94th Congress } COMMITTEE PRINT
2d Session }

TAX EXPENDITURES

Compendium of Background Material on Individual Provisions

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

MARCH 17, 1976

Printed for the use of the Committee on the Budget

U.S. GOVERNMENT PRINTING OFFICE
67-312 WASHINGTON : 1976

For sale b the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C., 20402 - Price $2.20

COMMITTEE ON THE BUDGET

EDMUND S. MUSKIE, Maine, *Chairman*

WARREN G. MAGNUSON, Washington
FRANK E. MOSS, Utah
WALTER F. MONDALE, Minnesota
ERNEST F. HOLLINGS, South Carolina
ALAN CRANSTON, California
LAWTON CHILES, Florida
JAMES ABOUREZK, South Dakota
JOSEPH R. BIDEN, Jr., Delaware
SAM NUNN, Georgia

HENRY BELLMON, Oklahoma
ROBERT DOLE, Kansas
J. GLENN BEALL, Jr., Maryland
JAMES L. BUCKLEY, New York
JAMES A. McCLURE, Idaho
PETE V. DOMENICI, New Mexico

DOUGLAS J. BENNET, Jr., *Staff Director*
JOHN T. McEVOY, *Chief Counsel*
ROBERT S. BOYD, *Minority Staff Director*
W. THOMAS FOXWELL, *Director of Publications*

LETTER OF TRANSMITTAL

To the Members of the Committee on the Budget:

The Congressional Budget and Impoundment Control Act of 1974 requires that the Budget Committees and the Congress examine tax expenditures as part of overall Federal budgetary policy. This requirement stems from a recognition that numerous provisions of Federal tax law confer benefits on some individuals and institutions that are comparable to direct Federal spending, but that these tax law benefits seldom are reviewed, in comparison with direct spending programs.

This Committee print has been prepared to gather together basic background information concerning tax expenditures to assist members of the Budget Committee and other Members of the Congress in carrying out their responsibilities with respect to tax expenditures under the Budget Act. It is a compendium of summaries which describes the operation and impact of each tax expenditure; indicates the authorization and rationale for its enactment and perpetuation; estimates both the revenue loss attributable to each provision and, where provisions affect individual taxpayers directly, the percentage distribution by adjusted gross income class of the tax savings conferred by the provision; and cites selected bibliography for each provision.

The concept of tax expenditures is a relatively new one which is still in the process of being refined, both with respect to the provisions classified as tax expenditures and the methods of calculating the revenue losses stemming from such provisions. Nevertheless, failure to take tax expenditures into account in the budget process now would be to overlook significant segments of Federal policy. They should be given particularly thorough scrutiny because, as the compendium indicates, tax expenditures are generally enacted as permanent legislation and thus are comparable to continuing direct spending entitlement programs, often with increasing annual revenue losses.

This compendium was prepared jointly by Jane Gravelle of the Congressional Research Service, Ronald Hoffman, Charles Davenport, John Roth, and Roger Golden of the Congressional Budget Office, and Ira Tannenbaum, Kenneth Biederman, and Bert Carp of the Budget Committee staff.

Nothing in this compendium should be interpreted as representing the views or recommendations of the Budget Committee or any of its individual members.

Sincerely,

Henry Bellmon,
Ranking Minority Member.

Edmund S. Muskie,
Chairman.

Walter F. Mondale,
Chairman, Task Force on Tax Policy, and Tax Expenditures.

CONTENTS

INTRODUCTION

This compendium gathers basic information concerning 74 Federal income tax provisions currently treated as tax expenditures. The provisions included in this compendium are the same as those listed in *Estimates of Federal Tax Expenditures*, prepared for the Committee on Ways and Means and the Committee on Finance by the staffs of the Treasury Department and Joint Committee on Internal Revenue Taxation (July 8, 1975). With respect to each of these expenditures, this compendium provides:

An estimate of the Federal revenue loss associated with the provision for individual and corporate taxpayers, for fiscal years 1975, 1976, and 1977;

The legal authorization for the provision (e.g., Internal Revenue Code section, Treasury Department regulation, or Treasury ruling);

A description of the tax expenditure, including an example of its operation where this is useful;

A brief analysis of the impact of the provision;

An estimate, where applicable, of the percentage distribution—by adjusted gross income (AGI) class—of the individual income tax saving resulting from the provision;

A brief statement of the rationale for the adoption of the tax expenditure where it is known, including relevant legislative history; and

References to selected bibliography.

The information presented for each of these tax expenditures is not intended to be exhaustive or definitive. Rather, it is intended to provide an introductory understanding of the nature, effect, and background of each of these provisions. Good starting points for further research on each item are listed in the selected bibliography following each provision.

Defining Tax Expenditures

Tax expenditures are revenue losses resulting from Federal tax provisions that grant special tax relief designed to encourage certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances. These provisions may, in effect, be viewed as the equivalent of a simultaneous collection of revenue and a direct budget outlay of an equal amount to the beneficiary taxpayer.

Section 3(a)(3) of the Congressional Budget and Impoundment Control Act of 1974 specifically defines tax expenditures as:

> . . . those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability; . . . .

In the legislative history of the Congressional Budget Act, provisions classified as tax expenditures are contrasted with those provisions which are part of the "normal structure" of the individual and corporate income tax necessary to collect government revenues.

The concept of tax expenditures is relatively new, having been developed over only the past decade. Tax expenditure budgets which list the estimated annual revenue losses associated with each tax expenditure first were required to be published in 1975 as part of the Administration budget for FY 1976, and will be required to be published by the Budget Committees for the first time this April. The tax expenditure concept is still being refined, and therefore the classification of certain provisions as tax expenditures continues to be discussed. Nevertheless, there is widespread agreement for the treatment as tax expenditures of most of the provisions included in this compendium.[1]

The listing of a provision as a tax expenditure in no way implies any judgment about its desirability or effectiveness relative to other tax or nontax provisions that provide benefits to specific classes of individuals and corporations. Rather, the listing of tax expenditures, taken in conjunction with the listing of direct spending programs, is intended to allow Congress to scrutinize all Federal programs—both nontax and tax—when it develops its annual budget. Only if tax expenditures are included will Congressional budget decisions take into account the full spectrum of Federal programs.

In numerous instances, the goals of these tax expenditures might also be achieved through the use of direct expenditures or loan programs. Because any qualified taxpayer may reduce tax liability through use of a tax expenditure, such provisions are comparable to entitlement programs under which benefits are paid to all eligible persons. Since tax expenditures are generally enacted as permanent legislation, it is important that, as entitlement programs, they be given thorough periodic consideration to see whether they are efficiently meeting the national needs and goals that were the reasons for their initial establishment.

Major Types of Tax Expenditures

Tax expenditures may take any of the following forms: (1) exclusions, exemptions, and deductions, which reduce taxable income; (2) preferential tax rates, which reduce taxes by applying lower rates to part or all of a taxpayer's income; (3) credits, which are subtracted from taxes as ordinarily computed; and (4) deferrals of tax, which result from delayed recognition of income or from allowing in the current year deductions that are properly attributable to a future year.[2]

The amount of tax relief per dollar of each exclusion, exemption, and deduction increases with the taxpayer's marginal tax rate. Thus, the exclusion of interest income from State and local bonds saves $50 in tax for every $100 of interest for the taxpayer in the 50 percent tax bracket, whereas the savings for the taxpayer in the 25 percent bracket is only $25. Similarly, the extra exemption for persons over age 65 and

[1] For a discussion of some of the conceptual problems involved in defining tax expenditures, see *Budget of the United States Government, Fiscal year 1977*, "Special Analysis F", 116-122.

[2] See Appendix A for further analysis of these types of tax expenditures.

any itemized deduction is worth twice as much in tax saving to a taxpayer in the 50 percent bracket as to one in the 25 percent bracket.

A tax credit is subtracted directly from the tax liability that would otherwise be due; thus the amount of tax reduction is the amount of the credit—which does not depend on the marginal tax rate.

The numerous tax expenditures that take the form of exclusions, deductions, and exemptions are relatively more valuable to upper than to lower or middle income individuals. However, this fact should be viewed in the context of recent increases in the low-income allowance and in the standard deduction, which provide more tax saving for certain low-middle income taxpayers than itemized deductions, thus reducing the number of them who itemize.

Moreover, even though some tax expenditures may provide most of their tax relief to those with high taxable incomes, this may be the consequence of overriding economic considerations. For example, tax expenditures directed toward capital formation may deliberately benefit savers who are primarily higher income taxpayers.

Estimating Tax Expenditures

The estimated revenue losses for all the listed tax expenditures have been provided by the Congressional Budget Office (CBO) based upon work done by the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation.[3] Except for five expenditures, the estimates are identical to those that appear for the same provisions in the Administration's FY 1977 tax expenditure budget.[4] Most of these differences stem from CBO assumptions that certain tax expenditures scheduled to expire during 1976 will be continued through FY 1977.

In calculating the revenue loss from each tax expenditure, it is assumed that only the provision in question is deleted and that all other aspects of the tax system remain the same. In using the tax expenditure estimates, several points should be noted.

First, in some cases, if two or more items were eliminated, the combination of changes would probably produce a lesser or greater revenue effect than the sum of the amounts shown for the individual items.

Second, the amounts shown for the various tax expenditure items do not take into account any effects that the removal of one or more of the items might have on investment and consumption patterns or on any other aspects of individual taxpayer behavior, general economic activity, or decisions regarding other Federal budget outlays or receipts.

Finally, the revenue effect of new tax expenditure items added to the tax law may not be fully felt for several years. As a result, the eventual annual cost of some provisions is not fully reflected until some time after enactment. Similarly, if items now in the law were eliminated, it is unlikely that the full revenue effects would be immediately realized.

[3] The revenue estimates are based on the tax code as of January 1, 1976, with the exception that the temporary provisions applying to the investment credit, surtax exemption, earned income credit, and the standard deduction are estimated as if they will continue through FY 1977.

[4] *The Budget of the United States Government*, Fiscal Year 1977, "Special Analysis F" at 125–127.

However, these tax expenditure estimating considerations are similar to estimating considerations involving entitlement programs. Like tax expenditures, annual budget estimates for each transfer and income security program are computed separately. However, if one program, such as veterans' pensions, were either terminated or increased, this would affect the level of payments under other programs, such as welfare payments. Also, like tax expenditure estimates, the elimination or curtailment of a spending program, such as military spending or unemployment benefits, would have substantial effects on consumption patterns and economic activity that would directly affect the levels of other spending programs. Finally, like tax expenditures, the budgetary effect of terminating certain entitlement programs would not be fully reflected until several years later because the termination of benefits is usually only for new recipients with persons already receiving benefits continued under "grandfather" provisions.

Adjusted Gross Income Class Distributions

Distributions of the tax benefits by adjusted gross income (AGI) class are given for almost all tax expenditures providing direct tax relief to individual taxpayers. These distribution figures show the portion of the total estimated revenue loss attributed to each tax expenditure that goes to all taxpayers with adjusted gross income falling within the boundaries of the respective income classes. No distribution to individual income classes is made of the tax expenditure benefits provided directly to corporations, since to do so would require unsubstantiated assumptions concerning the ultimate beneficiaries of these corporate tax relief provisions.

Taxable individual income tax returns falling within each AGI class for calendar 1974 were:

AGI class	Taxable returns (thousands)	Percent of taxable returns in each class
0 to $7,000	19,909	29.7
$7,000 to $15,000	27,380	40.9
$15,000 to $50,000	18,862	28.2
$50,000 and over	815	1.2

The tax expenditure distributions by AGI class are taken from a study done by the Treasury Department in 1975 at the request of Senator Walter F. Mondale of Minnesota and are the most recent estimates of this type.

These distributions indicate in a general way whether specific tax expenditures provide tax benefits largely to lower, middle, or high income taxpayers. However, adjusted gross income includes less than a fully comprehensive definition of income. It is total gross (non-exempt) income reduced by allowable deductions. Adjusted gross income will differ substantially from a more inclusive definition of money income where individuals have relatively large amounts of income which, pursuant to one or more tax expenditure provisions, are exempt from tax. For example, the exclusion of income earned by certain U.S. citizens working or residing abroad (see p. 13) permits up to $25,000 a year of economic income to be excluded from adjusted gross income. Thus, many of the provision's beneficiaries will appear in the $0 to $7,000 AGI class, giving the appearance the provision largely benefits low income persons. However, in fact, many of these persons actually earned salaries in the area of $20,000 to $30,000.

Order of Presentation

The tax expenditures are presented in an order which parallels as closely as possible, the budget functional categories used in the Congressional budget, i.e., tax expenditures related to "national defense" are listed first, and those related to "international affairs" are listed next.

This order of presentation differs to a limited degree from that used in the tax expenditure budgets published by the Administration for 1976 and 1977 and prepared by the staffs of the Joint Committee on Internal Revenue Taxation and the Treasury Department for 1976. These budgets listed certain items under three headings—"business investment", personal investment", and "other tax expenditures"—that are not budget functional categories. However, in order that tax expenditures be presented in a manner which parallels as closely as possible the presentation of direct expenditures, the items that were listed under those three headings have been distributed in this compendium to the budget functional categories to which they are most closely related. This format is consistent with the requirement of Section 301(d)(6) of the Budget Act, which requires the tax expenditure budgets published by the Budget Committees as parts of their April 15 reports to present the estimated levels of tax expenditures "by major functional categories".

Rationale

The material on each tax expenditure contains a brief statement of the rationale for the adoption of the tax expenditure where it is known. These rationales are the principal ones which were publicly given at the time the provisions were enacted.

Further Comment

In the case of a number of tax expenditures, additional information is provided under the heading "Further Comment." It is material which either focuses attention on some of the principal issues related to a provision or describes recent legislative proposals to amend a provision. This is material that does not fit within the other elements of the format of the compendium—either in the "Description," "Impact," or "Rationale" sections. As the examples which are provided in the descriptions of only some of the tax expenditures, the "Further Comment" sections are included only where they were deemed to be useful. Providing information under the "Further Comment" sections for only certain tax expenditures in no way implies any judgment about these provisions.

EXCLUSION OF BENEFITS AND ALLOWANCES TO ARMED FORCES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	650	------	650
1976	650	------	650
1975	650	------	650

Authorization

Sections 112 and 113,[1] Regulation § 1.61–2,[2] and court decisions.

Description

Military personnel are not taxed on a variety of in-kind benefits and cash payments given in lieu of such benefits. These tax-free benefits include quarters and meals or—alternatively—cash allowances for these purposes, certain combat pay, and a number of less significant items.

Impact

All military personnel receive one or more of these benefits which are generally greater in the higher pay brackets. The amount of tax relief increases with the individual's tax bracket and therefore depends on a variety of factors unrelated to the taxpayer's military pay, such as other income including income from a spouse, and the amount of itemized deductions. Therefore, the exclusion of these benefits from taxation alters the distribution of net pay to service personnel.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	46. 9
7 to 15	36. 2
15 to 50	16. 2
50 and over	0. 8

[1] The word "Section" denotes a section of the Internal Revenue Code of 1954 as amended unless otherwise noted.
[2] Reference to "regulations" are to Income Tax Regulations unless otherwise noted.

Rationale

Although the principle of exemption of Armed Forces benefits and allowances appeared early in the history of the income tax, it has evolved through subsequent specific statute, regulations, revenue rulings, and court decisions. For some benefits, the rationale was a specific desire to reduce tax burdens of military personnel during wartime (as in the use of combat pay provisions); other preferences were apparently based on the belief that certain types of benefits were not strictly compensatory but rather an intrinsic element in the military structure.

Further Comment

Administrative difficulties and complications could be encountered in taxing some military benefits and allowances that are tax exempt; for example, it could be difficult to value meals and lodging when the option to receive cash is not available. However, eliminating the exclusions and adjusting pay scales accordingly might simplify decision-making about military pay levels and make "actual" salary more apparent to recipients.

Selected Bibliography

Binkin, Martin. *The Military Pay Muddle*, The Brookings Institution, Washington, D.C., April 1975.

EXCLUSION OF MILITARY DISABILITY PENSIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	90	------	90
1976	80	------	80
1975	70	------	70

Authorization

Section 104(a)(4) and Regulation §1.104–1(e).

Description

Service personnel who have at least a 30-percent disability or who have at least 20 years of service and any amount of disability may draw retirement pay based on either percentage of disability or years of service. If the chosen pension is less than 50 percent of the basic pay, it will be raised to 50 percent during the first 5 years of retirement. Pay based on percentage of disability is fully excluded from gross income under Section 104. If pay is based on years of service, only the portion that would have been paid on the basis of disability is excluded from income.

Impact

Because it is exempt from tax, disability pay provides more net income than taxable benefits at the same level. The tax benefit of this provision increases as the pensioner's marginal tax rate increases. Thus, the after-tax pension benefits increase as a percentage of active duty pay as the individual's tax bracket increases.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	46. 2
7 to 15	36. 9
15 to 50	16. 9
50 and over	0

Rationale

The rationale for this exclusion is not clear. It was adopted in 1942 during World War II.

Selected Bibliography

Binkin, Martin. *The Military Pay Muddle,* The Brookings Institution, Washington, D.C., April 1975.

EXCLUSION OF GROSS-UP ON DIVIDENDS OF LESS DEVELOPED COUNTRY CORPORATIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	------	55	55
1976	------	55	55
1975	------	55	55

Authorization

Sections 78 and 902 and Executive Order No. 11071, December 27, 1962.

Description

A domestic corporation that receives dividends from a foreign corporation in which the domestic corporation owns 10 percent or more of the voting stock may claim a foreign tax credit against its U.S. tax liability for the foreign income taxes paid by the subsidiary. If the foreign corporation is not a less developed country corporation (LDCC), the dividend must be "grossed-up" (i.e., increased) by the amount of foreign tax paid with respect to the dividend. The "grossed-up" amount is included in taxable income, and the U.S. tax rate is applied to the "grossed-up" taxable income to calculate the U.S. tax. The foreign tax may then be credited against (i.e., deducted from) the U.S. tax. However, dividends paid by LDCCs are not "grossed-up," but foreign taxes paid with respect to them are available as a foreign tax credit. To qualify as an LDCC, a corporation must have 80 percent or more of its gross income and assets connected with activities in less developed countries. Shipping companies with ships or aircraft registered in less developed countries qualify. Pursuant to Executive Order No. 11071 of December 27, 1962, all countries qualify as less developed except 16 Western European nations, Australia, New Zealand, South Africa, Canada, and Sino-Soviet bloc members.

Example

Assume the foreign tax rate is 24 percent, and an LDCC earns $100, pays a foreign tax of $24, and distributes the remaining $76 as a dividend. If "gross-up" is required, the U.S. tax before the credit is $48 (48 percent—the U.S. corporate tax rate—of $100) and the $24

67-312—76——2

foreign tax payment is credited against the $48 resulting in a $24 U.S. liability after the credit. Thus, the total tax rate, including both the foreign and U.S. tax, is 48 percent which is equal to the U.S. rate. If "gross-up" is not required, then the U.S. tax is $36.48 (48 percent of $76) less $18.24 (24 percent of $76), which is the amount of the foreign tax paid on the dividend and which therefore can be credited. Thus, the net U.S. tax liability is $18.24, a total tax rate of 42.24 percent ($18.24 plus $24.00 divided by $100). Failure to "gross-up" therefore saves the parent corporation $5.76 ($24.00−$18.24) of U.S. taxes.

Impact

Income remitted to parent companies by LDCCs is taxed at a lower rate than dividends from other subsidiaries. The amount of the benefit depends on the tax rate of the foreign country relative to the U.S. tax rate. The benefit is greatest when the foreign tax rate is half the 48 percent U.S. tax rate. In this case, the total U.S. and foreign tax is 42.24 percent (see the example above). The benefit declines as the foreign tax rate rises above or falls below half the U.S. tax rate; thus the net U.S. tax liability varies with the foreign effective tax rate. There is no benefit when the foreign tax rate equals or exceeds the U.S. tax rate and no benefit when the foreign tax rate is zero.

Rationale

The "gross-up" requirement for developed countries was added in 1962. Prior to that time, "gross-up" was not required, and the method of computing the tax was derived from a 1942 Supreme Court decision (*American Chicle Co.* v. *U.S.*, 316 U.S. 450) which interpreted the language of the provision allowing a foreign tax credit. While the 1962 revision recognized that this provision should be corrected generally, the Finance Committee recommended exempting dividends from LDCCs from this requirement because it did not wish to discourage investment in such countries.

Further Comment

This preferential treatment for LDCC dividends would be eliminated by H.R. 10612, passed by the House in December 1975.

Selected Bibliography

Hellawell, Robert, "United States Income Taxation and Less Developed Countries: A Critical Appraisal," *Columbia Law Review*, December 1966, pp. 1393–4277.

U.S. Congress, House, Committee on Ways and Means, *General Tax Reform*, Panel Discussions, 93rd Congress, 1st Sess., Part II—Tax Treatment of Foreign Income, February 28, 1973, pp. 1671–1881.

EXCLUSION OF CERTAIN INCOME EARNED ABROAD BY U.S. CITIZENS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	160	------	160
1976	145	------	145
1975	130	------	130

Authorization

Sections 911–912.

Description

While U.S. citizens are generally taxable on their world-wide income, up to $20,000 of foreign earned income (largely salary income) may be excluded annually from income under section 911 by a citizen who (1) is a bona fide resident of a foreign country for an uninterrupted period that includes a taxable year, or (2) has been present in a foreign country for 510 days (17 months) out of 18 consecutive months. The annual exclusion is raised to $25,000 for an individual who has been a bona fide resident of a foreign country for at least 3 consecutive years. Section 911 does not apply to salaries received from the U.S. Government.

Section 912 exempts from tax certain allowances that are received by Federal civilian employees working abroad. The principal exempt allowances are for high local living costs, education, and housing.

Impact

Some U.S. citizens living abroad pay no income taxes to the countries in which they reside. Section 911 allows their income up to the appropriate ceiling to be tax free in the United States as well.

In cases where U.S. citizens pay foreign income taxes, those taxes, including the taxes paid on the income excluded from taxation under this section, can be credited against any U.S. tax liability that would otherwise exist on other foreign income: earned income above the $20,000 or $25,000 excludable limits and investment income. This allows U.S. taxpayers to offset all the foreign tax—including that paid on the amount of excluded income—against U.S. tax that would otherwise be due on the income in excess of the excluded amount. Thus, the combination of the exclusion and the foreign tax credit can result in levels of income actually exempt from U.S. tax in excess of the stated limits.

In addition to the U.S. citizens who directly benefit from this favorable treatment, overseas employers also benefit to the extent that salary levels are lower because of the exclusion. To the extent this occurs, they maintain an advantage relative to domestic employers. U.S. corporations that bid on overseas construction projects assert that the salary savings make them more competitive with foreign bidders, some of the employees of which also enjoy similar salary savings.

The value of the Section 912 exemption for allowances received by Federal civilian employees working abroad increases with the recipient's tax bracket. The value therefore depends on a variety of factors including the level of the recipient's Federal salary, the extent of his other income, and the amount of his itemized deductions.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	Percentage distribution
0 to 7	38.9
7 to 15	17.8
15 to 50	34.4
50 and over	8.9

Rationale

A less restrictive form of Section 911 was first enacted in 1926 to encourage foreign trade. After World War II, the exclusion was justified as part of the Marshall Plan to encourage persons with technical knowledge to work abroad. Although the provision was revised on several occasions, dollar limitations were first enacted in 1953 at $20,000 and $35,000. The latter figure was reduced to $25,000 in 1964.

The exemption for civilian Federal employee overseas allowances was enacted in 1943. The principal rationale was to provide additional compensation for these employees, who were performing vital wartime services.

Further Comment

H.R. 10612 passed by the House of Representatives in December 1975 would phase out Section 911 over a 3-year period. However, it would provide a new tax deduction for amounts paid as tuition for children of U.S. citizens working abroad.

Selected Bibliography

U.S. Congress, House, Committee on Ways and Means, *General Tax Reform*, Panel Discussion, 93rd Congress, 1st Session, Part II—Tax Treatment of Foreign Income, February 28, 1973, pp. 1671–1888.

DEFERRAL OF INCOME OF DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISCs)

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	-------	1,420	1,420
1976	-------	1,340	1,340
1975	-------	1,130	1,130

Authorization

Sections 991–997.

Description

Corporations qualifying as DISCs (Domestic International Sales Corporations) must be incorporated in the United States, at least 95 percent of their assets must be related to export functions, and at least 95 percent of their gross receipts must stem from export sale or lease transactions.

DISCs typically are wholly owned subsidiary corporations through which parent corporations channel their export sales. DISCs are not themselves subject to corporate income tax, but their parent corporations are taxed on the DISC income when it is distributed or attributed to them.

The tax savings from using a DISC result principally from two interrelated aspects of the tax law: (1) the allocation rules that allow at least half of the total, combined profit of the parent and DISC from export sales to be attributed to the DISC, and (2) the potentially permanent tax deferral that is allowed on half of those profits attributed to the DISC under the liberal allocation rules. The other half of a DISC's income is either actually or deemed to be distributed annually to its parent corporation and thus does not qualify for deferral.

The allocation rules provide that a DISC is deemed to have earned either: (1) 50 percent of the combined taxable income of the parent corporation and DISC from export sales or (2) 4 percent of the gross receipts from the export sales, whichever is greater. The 50 percent allocation is used much more frequently. The rules for allocating DISC profits are much more favorable than the otherwise applicable tax law standard (Section 482) which requires a sale by a manufacturer or producer to a wholly owned sales subsidiary to be at an arm's length price. If the Section 482 rule were applied to DISCs, only a relatively small, or no, sales commission would be allocated to the

DISC, while the proportionately larger profits from production would go to the parent corporation.

The deferral of tax (on 50 percent of the income allocated to the DISC) continues as long as the undistributed DISC income is invested in qualified assets; the duration may be indefinite, and in such cases constitutes the practical equivalent of a permanent tax exemption.

Example

Assume a company incurs total costs of $8,000 in producing goods selling on the export market for $10,000. The allocation rule attributes 50 percent of the $2,000 total net profit to the DISC and 50 percent to the parent firm. Taxes are deferred on $500 of the $1,000 allocated to the DISC and the 48 percent corporate tax rate is applied to the remaining $1,500 of direct profits and DISC earnings attributed or paid to the parent firm. The total tax liability is $720. If a DISC had not been used, the tax liability would have been $960 ($2,000 × .48 tax rate). The DISC provides a tax savings of $240 ($500 of deferrable DISC income × .48 tax rate) and, therefore, lowers the effective tax rate to 36 percent on this export sales income.

Impact

This provision reduces the marginal tax rate on DISC-related export income from 48 percent to 36 percent (and to 24 percent in the relatively few cases where the total profit on export sales of the DISC and its parent is no more than 4 percent of gross export receipts).

Whether U.S. exporters reduce export prices in response to reduced effective tax rates is unclear. To the extent they do, foreign purchasers, as well as domestic exporters, would be subsidized.

According to several studies, the overall impact of DISC in stimulating exports has been small in comparison to its annual revenue cost. U.S. exports have increased dramatically since the DISC provisions were added, but the increase is said to be due to the devaluations of the dollar, worldwide inflation, and a stable U.S. share of expanding worldwide trade. On the other hand, many companies which utilize DISC argue it should be retained because: (1) in their view, DISC has substantially increased exports which, in turn, have increased U.S. employment levels; and (2) other countries employ a variety of export promotion devices.

Corporations with profitable export operations benefit from the tax reduction. The Treasury Department study cited below in the bibliography reported that 72 percent of the net income of 1,510 DISCs with corporate owners for which asset size data were available accrued to 186 companies with gross assets in excess of $250 million, with 44 percent going to only 28 companies.

Rationale

Originally adopted as part of the Revenue Act of 1971, the stated purpose of DISC was to stimulate exports and enhance the attractiveness of domestic manufacturing vis-a-vis manufacturing through foreign subsidiaries.

Further Comment

H.R. 10612, passed by the House in December 1975, would reduce current DISC benefits by roughly one-third by limiting income qualifying for deferral to that earned by exports in excess of 75 percent of a company's exports during a prescribed base period.

Selected Bibliography

U.S. Congress, House, Committee on Ways and Means, *General Tax Reform*, Panel Discussions, 93rd Congress, 1st Session, Part II—Tax Treatment of Foreign Income, February 28, 1973, pp. 1671–1880.

U.S. Congress, Senate, Task Force on Tax Policy and Tax Expenditures, Committee on the Budget, *Seminar—DISC: An Evaluation of the Costs and Benefits*, Committee Print, November 1975.

U.S. Department of Treasury, "The Operation and Effect of the Domestic International Sales Corporation Legislation," 1973 Annual Report, April 1975, 30 pages.

SPECIAL RATES FOR WESTERN HEMISPHERE TRADE CORPORATIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	------	50	50
1976	------	50	50
1975	------	50	50

Authorization

Sections 921 and 922.

Description

Western Hemisphere Trade Corporations (WHTCs) are granted a special deduction which has the effect of reducing the tax rate by as much as 14 percentage points.[1] The amount of the special deduction is the taxable income of the corporation (before the special deduction) multiplied by a fraction, the numerator of which is 14 percent and the denominator of which is the overall rate (i.e. the sum of the normal tax rate and the surtax rate) on the corporation's total taxable income.

A WHTC is a U.S. corporation: (1) all of whose business is done in the Western Hemisphere; (2) 95 percent or more of whose income over the last three years was derived from sources outside the U.S.; and (3) 90 percent or more of whose income over the same three years was derived from the active conduct of a trade or business.

WHTCs may not defer U.S. taxation of their income (as in the case of a controlled foreign corporation), but they may take a tax credit for foreign taxes imposed on that income. The WHTC deduction may not be taken for a taxable year in which the corporation is a Domestic International Sales Corporation (DISC) or in which it owns any stock in a DISC or former DISC.

Example

If taxable income is $100,000 when computed without regard to the WHTC deduction, the WHTC deduction equals $100,000 × (14 percent/48 percent)=$29,166.67; taxable income is reduced to

[1] Under the permanent corporate rate structure, the full 14 percentage point reduction applies to all WHTCs with income in excess of $35,294. Corporations with less income obtain a deduction which will reduce their tax rate by less than 14 percentage points. Under the temporary tax reductions in the Tax Reduction Act of 1975 and the Revenue Adjustment Act of 1975 which expire on June 30, 1976, the principle remains the same, but the cut-off figure for the full 14 percent reduction is slightly higher.

$70,833.34, and tax liability on this amount is $27,500 (assuming a 22% rate on the first $25,000 of taxable income and a 48% rate on the income in excess of $25,000). Without this special deduction the tax would have been $41,500. Thus, the effective tax rate has been reduced by 14 percentage points.

Impact

For many companies, tax deferral through foreign incorporation has been more advantageous than the WHTC provision. But, because only domestic corporations may take percentage depletion, companies with Western Hemisphere extractive industry operations outside the U.S. were traditionally organized as WHTCs. Currently, however, the WHTC provision yields little or no tax saving for such operations because the application of large foreign tax credits completely or nearly completely offsets any U.S. tax liability.

The WHTC provision also has been used by sales subsidiaries. However, the more recent DISC legislation can be more valuable in many cases, and the absence of growth in use of WHTCs may reflect replacement of WHTC sales subsidiaries by DISCs.

Rationale

The Revenue Act of 1942 enacted the WHTC provisions to exempt a few corporations then engaged in operations outside the United States but within the Western Hemisphere from the high wartime corporate surtaxes. The current provisions were continued in 1950 when the tax structure was changed. The WHTC treatment is now justified by some persons as necessary to maintain the competitive position of corporations competing in the Western Hemisphere with foreign corporations.

Further Comment

H.R. 10612, passed by the House of Representatives in December 1975, would phase out this provision by the end of taxable years that begin in 1980.

Selected Bibliography

Musgrave, Peggy, "Tax Preferences to Foreign Investment" in U.S. Congress, Joint Economic Committee, *The Economics of Federal Subsidy Programs*, Part 2—International Subsidies, 92nd Congress, 2nd Session, July 15, 1972, p. 195.

Surrey, Stanley S., "Current Issues in the Taxation of Corporate Foreign Investment", *Columbia Law Review*, June 1956, pp. 830–838.

U.S. Congress, House Committee on Ways and Means, *General Tax Reform*, Panel Discussion, Part II—Tax Treatment of Foreign Income, 93rd Congress, 1st Session, February 28, 1973, pp. 1671–1888.

U.S. Congress, Joint Committee on Internal Revenue Taxation, *U.S. Taxation of Foreign Source Income of Individuals and Corporations and the Domestic International Sales Corporation Provisions*, September 29, 1975.

DEFERRAL OF INCOME OF CONTROLLED FOREIGN CORPORATIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	------	365	365
1976	------	525	525
1975	------	590	590

Authorization

Sections 11(f), 882, and 951–964.

Description

A U.S. corporate parent of a foreign subsidiary is not taxed on the income of that subsidiary until the income is remitted (or "repatriated") to the parent. The deferral of U.S. tax liability on the subsidiary's income is permanent to the extent that the income is reinvested in the subsidiary or other foreign subsidiaries rather than remitted to the U.S. parent. A tax credit in the amount of foreign taxes paid on repatriated income, plus any "gross up" required (see page 11), is allowed at the time of repatriation.

On the other hand, income from foreign branches (as distinguished from subsidiaries) of U.S. corporations is taxed on a current basis since the branches are parts of U.S. corporations. Certain so-called tax haven income also is taxed currently in the U.S. irrespective of whether earned by a foreign subsidiary or a branch. The Tax Reduction Act of 1975 strengthened the provisions requiring current taxation of such income.

Impact

Companies that operate in countries with effective income tax rates less than the U.S. rate may receive tax benefits from this provision.

A substantial portion of the revenue loss is attributable to deferral on shipping income, which is estimated to account for over $100 million of the current revenue loss. This occurs because shipping firms are often based in countries without income taxes, such as Liberia and Panama. U.S. Department of Commerce data indicate that 423 of the 678 foreign flag ships owned by U.S. corporations and their subsidiaries are registered in Panama or Liberia. Much (485) of this total shipping fleet is composed of tankers.

Rationale

Historically, the United States has not taxed foreign source income of foreign corporations on the premise that only domestic corporations or income with a U.S. source is subject to U.S. jurisdiction. In effect, the separate corporate status of foreign subsidiaries of domestic corporations was respected. In 1962 these principles were abrogated for certain so-called tax haven income under subpart F of the Code. Such income is taxed even though earned abroad and even though not repatriated.

Further Comment

Opponents of deferral allege it encourages investment in foreign countries and reduces domestic investment, thus reducing U.S. tax revenues and U.S. exports, and adversely affecting the balance of payments, the balance of trade, and domestic employment. Proponents deny such allegations and argue that deferral must be continued for U.S. corporations to remain competitive with foreign companies in overseas markets.

Deferral of tax on foreign profits is not neutral compared to investment in the United States in the sense that if the foreign country tax rate is less than the U.S. tax rate and the income is not going to be repatriated, a U.S. corporation has a tax incentive to invest abroad using a foreign subsidiary instead of investing at home. However, the deferral rules do neutralize advantages foreign competitors may have over U.S. corporations operating abroad. Moreover, there are also offsetting tax rules which favor investment in the U.S. by domestic companies rather than abroad such as the general limitation of the investment credit and asset depreciation range (ADR) depreciation to assets used in the United States.

Selected Bibliography

Krause, Lawrence B. and Kenneth W. Dam. *Federal Tax Treatment of Foreign Income*, The Brookings Institution, Washington, D.C. 1964, 145 pages.

Musgrave, Peggy, "Tax Preferences to Foreign Investment," in U.S. Congress, Joint Economic Committee, *The Economics of Federal Subsidy Programs*, Part 2—International Subsidiaries, 92nd Congress, 2nd Session, July 15, 1972, pp. 176–219.

U.S. Congress, House, Committee on Ways and Means, *General Tax Reform*, Panel Discussions, 93rd Congress, 1st Session, Part II—Tax Treatment of Foreign Income, February 28, 1973, pp. 1671–1881.

U.S. Congress, House, Committee on Ways and Means, *U.S. Taxation of Foreign Income—Deferral and the Foreign Tax Credit*, Prepared by the Joint Committee on Internal Revenue Taxation, Committee Print, September 27, 1975.

U.S. Taxation of American Business Abroad. An Exchange of Views, A.E.I.—Hoover Policy Studies, American Enterprise Institute, Washington, D.C., 1975, 101 pages.

AGRICULTURE: EXPENSING OF CERTAIN CAPITAL OUTLAYS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	360	115	475
1976	355	105	460
1975	475	135	610

Authorization

Sections 162, 175, 180, 182, 278 and Regulations §§ 1.61–4, 1.162–11, and 1.471–6.

Description

Farmers may use the cash method of tax accounting to deduct costs attributable to goods held for sale and in inventory at the end of the tax year. They are also allowed to expense (i.e., deduct when they are incurred) some costs of developing assets that will produce income in future years. Both of these rules deviate from generally applicable tax accounting rules, which do not permit deduction of inventory costs until the inventory is sold, and which require the cost of income-producing assets to be deducted over their useful lives. These rules thus allow farmers to claim deductions before realizing the income associated with the deductions.

Items that may be deducted before income from them is realized include cattle feed, expenses of planting crops for the succeeding year's harvest, and development costs such as those incurred in planting vineyards and fruit orchards. There are special restrictions on the expensing of farming outlays for citrus and almond groves.

In addition, the statute allows expensing of certain items that otherwise might be considered capital expenditures rather than current expenses. These items include expenses for soil and water conservation (Section 175), land clearing (Section 182), and fertilizer (Section 180).

Impact

The effect of deducting costs before the associated income is realized is the understatement of income in that year followed by an overstatement of income when it is realized. The net result is that tax liability is deferred from the time the deduction is taken to the period of the asset's remaining useful life. This affords the taxpayer an interest-free loan in the amount of the deferred tax. When the income is finally taxed, it may be taxed at preferential capital gains rates (see p. 25 below).

The expensing of capital outlays is available to all taxpayers who have farm investments. Therefore, these rules provide a tax subsidy for all farming operations, and particularly for those with a long development period (such as orchards and vineyards).

Concern has focused on the use of farming as a tax shelter by high income bracket individuals who seek to offset their nonfarm taxable income with large, artificial, farming losses. Such investment packages normally have been characterized by a highly leveraged capital structure. To a high income taxpayer, this translates into a relatively riskless investment, since tax savings generated through the deduction of losses may return most or all of the initial cash outlay in the first year of operation.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class [1]

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	18.1
7 to 15	35.3
15 to 50	33.6
50 and over	12.9

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

The special rules with respect to development costs and cash accounting were established in regulations issued very early in the development of the tax law. At that time, because accounting methods were less sophisticated, tax rates were low, and the typical farming operation was small, the regulations apparently were adopted to simplify record keeping for the farmer. The statutory rules permitting deductions for soil and water conservation, land clearing expenses, and fertilizer costs were added between 1954 and 1962 to encourage conservation practices. The special restrictions on the expensing of farming outlays for citrus and almond growers were enacted in 1969.

The current use of cash basis accounting for farmers is justified by its proponents as much simpler, and more workable and consistent than the accrual method.

Selected Bibliography

U.S. Congress, House, Committee on Ways and Means, Panel Discussion on *General Tax Reform*, Part 5—Farm Operations, February 8, 1973, pp. 615–96.

U.S. Congress, House, Joint Committee on Internal Revenue Taxation, *Tax Shelters: Farm Operations*, Prepared for the Use of the Committee on Ways and Means, September 6, 1975, 25 pages.

U.S. Congress, House, Committee on Ways and Means, Tax Reform Hearings. *Tax Reform*, Part 2—Farm Operations, July 15, 1975, pp. 1360–1402.

AGRICULTURE: CAPITAL GAIN TREATMENT OF CERTAIN INCOME

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	565	40	605
1976	490	30	520
1975	455	30	485

Authorization

Sections 1201–1202, 1221–1223, 1231, 1245, and 1251–1252.

Description

If gains from the sale or exchange of property used in a trade or business exceed losses from such property in any year, the gain is treated as long term capital gain. Real estate or depreciable property used in farming operations and held for more than six months, but not held for sale, generally qualifies as such property. However, horses and cattle qualify only if they have been held more than 24 months, and all other livestock, more than 12 months.

In some cases, all or much of the cost of the farm property used in the business has previously been deducted under the farm accounting rules discussed on page 23. Consequently, in 1969, Congress enacted legislation to tax as ordinary income some gains previously taxed as capital gain. These gains are principally those from the sale of (a) land held for less than ten years, but only to the extent of previously deducted soil and water conservation expense, and (b) farm property, to the extent that prior farm losses exceeded $25,000 in any year in which the taxpayer had nonfarm income in excess of $50,000.

Impact

Subject to these rules, taxpayers owning farm assets may obtain long term capital gain treatment on qualifying assets even though much of the asset cost has been deducted against ordinary income. While this favorable tax treatment is limited to property used in the farming business, many farm assets have a dual potential of being held for sale or for use in the business. Assets having this ambiguous nature are often sold before the ambiguity is resolved, and the gain is treated as capital gain. Over 90 percent of the tax saving is claimed by noncorporate farmers. The tax benefit per dollar of capital gain increases with the taxpayer's marginal tax rate. The interaction between the deduction of costs and capital gain treatment for the sale of such assets has resulted in many tax shelter operations in farming.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class [1]

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	18. 3
7 to 15	35. 6
15 to 50	33. 7
50 and over	12. 5

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

Preferential treatment for capital gains for individuals was introduced in 1921. However, long term capital gain treatment for property used in a trade or business was not enacted until 1942. Between 1942 and 1951, there was a dispute whether livestock qualified as such property, and legislation in 1951 gave livestock that status. The 1942 legislation was enacted to provide tax relief for war-related gains.

Further Comment

Many proposals for changing the present law have been made from time to time. They include proposals to limit or eliminate the expensing of capital outlays, to impede tax shelter operations, to lengthen the holding periods for farm assets, and to change the definition of qualifying property.

Selected Bibliography

Carlin, Thomas A. and W. Fred Woods. *Tax Loss Farming,* ERS–546, Economic Research Service, U.S. Department of Agriculture, April 1974.

U.S. Congress, House, Committee on Ways and Means, *General Tax Reform.* Panel Discussions. Part 5—Farm Operations, February 8, 1973, pp. 615–96.

U.S. Congress, House, Joint Committee on Internal Revenue Taxation, *Tax Shelters: Farm Operations.* Prepared for the Use of the Committee on Ways and Means, September 6, 1975, 24 pages.

U.S. Congress, Committee on Ways and Means, *Tax Reform.* Hearings. Part 2—Farm Operations, July 15, 1975, pp. 1360–1402.

EXPENSING OF INTANGIBLE DRILLING, EXPLORATION AND DEVELOPMENT COSTS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	195	840	1,035
1976	155	650	805
1975	120	500	620

Authorization

Sections 263(c) and 616–617.

Description

Taxpayers engaged in drilling for oil and gas may deduct intangible drilling costs as incurred while taxpayers engaged in other mining activities may deduct exploration and development costs as incurred (i.e., these costs may be "expensed").

Intangible drilling costs are certain expenses incurred in bringing a well into production, such as labor, materials, supplies and repairs. Expenses for tangibles such as tanks and pipes are recovered through depreciation.

Mining exploration costs are those for the purpose of ascertaining the existence, location, extent or quality of a deposit incurred before the development stage, such as core drillings and testing of samples. nnnThese expenses are limited in the case of foreign exploration. Foreign exploration costs cannot be expensed after the taxpayer has total foreign and domestic exploration costs of $400,000. Development expenses include those incurred during the development stage of the mine such as constructing shafts and tunnels and in some cases drilling and testing to obtain additional information for planning operations. There are no limits on the current deductibility of such costs. Although both intangible drilling costs and mine development costs may be taken in addition to percentage depletion, mining exploration costs subsequently reduce percentage depletion deductions. In the case of mines, there are also "recapture" provisions under which capital gains from the sale of the property are taken as ordinary income to the extent of prior deductions for exploration expenses.

67–312—76——3

Impact

Generally, expenditures which improve assets that yield income over several years must be capitalized and deducted over the period in which the assets produce income. The tax advantage of treating these expenditures as current expenses is the same as any other allowing premature deductions; the taxpayer is allowed to defer current tax liabilities; this treatment amounts to an interest-free loan (see Appendix A).

These expensing provisions are additional benefits which supplement the special percentage depletion allowances extended to the mineral industry.[1] Although the expensing and depletion provisions operate somewhat independently, a firm or person may be eligible for both and receive their combined benefits.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class [1]

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	2.5
7 to 15	15.0
15 to 50	33.8
50 and over	48.8

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

The option to expense intangible drilling costs (as well as dry hole costs) of oil and gas wells developed through regulations issued in 1917 (19 Treas. Dec., Int. Rev. 31 (1917)). These regulations reflected the view that such costs were ordinary operating expenses. In 1942, the Treasury Department recommended that the provisions be removed, but Congress did not consider the suggestion. (Hearings on Revenue Revision of 1942 before the Committee on Ways and Means, p. 2996, Vol. 3, 77th Cong., 2nd Sess.) In 1945, when a court decision invalidated the regulations (*F.H.E. Oil Co.* v. *Commissioner*, 147 F.2d 1002, 5th Cir. 1945), Congress adopted a resolution (H. Con. Res. 50, 79th Cong., 1st Sess.) approving the treatment and later incorporated it into law in the 1954 Code. The legislative history of this resolution indicates that it was intended to reduce uncertainty in mineral exploration and stimulate drilling for military and civilian purposes. (H. Rep. No. 761, 79th Cong., 1st Sess., pp. 1–2.) Expensing of mine development expenditures was enacted in 1951 to reduce ambiguity in current treatment and encourage mining. The provision for mine exploration was added in 1966.

Prior to the Tax Reform Act of 1969, a taxpayer could elect either to deduct without dollar limitation exploration expenditures in the United States, which subsequently reduced percentage depletion benefits, or to deduct up to $100,000 a year with a total not to exceed $400,000 of foreign and domestic exploration expenditures without the application of the recapture rule. The 1969 Act subjected all post-1969 exploration expenditures to recapture.

[1] Percentage depletion has been eliminated for larger producers of oil and gas and is being reduced for other producers; see pages 31–32, below.

Selected Bibliography

Agria, Susan, "Special Tax Treatment of Mineral Industries," in *The Taxation of Income from Capital*, The Brookings Institution, Washington, D.C., 1969, pp. 77–122.

U.S. Congress, Senate, Committee on Interior and Insular Affairs, *An Analysis of the Federal Tax Treatment of Oil and Gas and Some Policy Alternatives*, 1974, 58 pages.

EXCESS OF PERCENTAGE OVER COST DEPLETION

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	575	1,020	1,595
1976	500	1,080	1,580
1975	465	2,010	2,475

Authorization

Section 613.

Description

Most firms engaged in oil, gas, and other mineral extraction are permitted to include in their business costs a "depletion" allowance for the exhaustion of the mineral deposits. Depletion is similar in concept to depreciation. The depletion allowance is used to recover the cost of a mineral deposit. There are two methods of calculating depletion: percentage depletion and cost depletion. Taxpayers who qualify for percentage depletion must use it if it is greater than cost depletion.

Under percentage depletion, a taxpayer deducts a fixed percentage of gross income from mining as a depletion allowance regardless of the amount invested in the deposit. The deduction for gas and oil (which was 27.5 percent from 1926–69) is now set at 22 percent. However, beginning in 1975 the percentage depletion allowance was repealed for major oil and gas companies. Other companies (independents) have been exempted from repeal of 2,000 barrels a day for 1975. The amount of this exempt portion is being phased down gradually to 1,000 barrels a day. In addition, beginning in 1981, the depletion rate will be gradually phased down to 15 percent for qualifying producers.

Percentage depletion also applies to other mineral resources at percentages currently ranging from 22 percent to 5 percent. Sulphur, uranium, and most other metals mined in the United States qualify for the 22 percent rate; however, domestic gold, silver, and iron ore qualify for a 15 percent rate; most minerals mined outside the U.S. qualify for a 14 percent rate; coal qualifies for a 10 percent rate; and several forms of clay, gravel, and stone qualify for 5 and 7½ percent rates.

Percentage depletion may not exceed 50 percent of the net income from the property. This limitation is known as the "net income limitation." The total cost which can be recovered by percentage depletion is *not* limited to the cost of the property.

Cost depletion resembles depreciation based upon the number of units produced. The share of the original cost deduction each year is equal to the portion of the estimated total production (over the lifetime of the well or mine) which is produced in that year. Using cost depletion, capital recovery cannot exceed the initial cost.

The value of the percentage depletion provision to the taxpayer is the amount of tax savings on the excess of the percentage depletion over cost depletion.

Impact

Issues of principal concern are the extent to which percentage depletion: (1) decreases the price of qualifying oil, gas and other minerals, and therefore encourages their consumption; (2) bids up the price of drilling and mining rights; and (3) encourages the development of new deposits and increases production.

Most analyses of percentage depletion have focused on the oil and gas industry, which prior to 1975 accounted for the bulk of percentage depletion. Since 1975 legislation repealed the percentage depletion allowance for most oil and gas production, only one-quarter of oil and gas production is estimated to be currently eligible for percentage depletion. Sales of all other mineral deposits were unaffected by the 1975 legislation.

Because of the prior focus on oil and gas percentage depletion, there has been relatively little analysis of the impact of percentage depletion on other industries. The relative value of the percentage depletion allowance in reducing the effective tax rate of mineral producers is dependent on a number of factors, including the statutory percentage depletion rate, the effect of the net income limitation, and the basic cost structure of the industry. For example, the greater the mining cost as a percentage of the selling price of the final mineral product, the greater the value of percentage depletion to the industry. This effect may account in part for the greater value of percentage depletion to the copper industry, as reported in SEC data as compared to the aluminum industry—since the mining of bauxite constitutes a much smaller portion of the cost of producing aluminum than the mining of copper does to the cost of finished copper.

In the past, the net income limitation kept the effective percentage depletion rate for coal at around 6 percent although the statutory rate is 10 percent. Because the rising price of imported oil has increased the average price of all oil, coal has been substituted for oil, resulting in dramatic increases in the price of coal. The price increases will make the net income limitation inapplicable to much coal production, so the effective depletion rate is likely to rise to nearly the statutory rate.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class [1]

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	3.3
7 to 15	9.8
15 to 50	31.8
50 and over	55.1

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

Deductions in excess of depletion based on cost were first allowed in 1918 in the form of "discovery value depletion" which allowed depletion on the market value of the deposit after discovery rather than on its cost. The purpose was to stimulate exploration during wartime and to relieve the tax burdens on small scale prospectors. Treasury believed that taxpayers often established high discovery values and thus claimed excessive depletion. In 1926, to avoid the administrative problems raised by the need to establish market value, Congress substituted percentage depletion for oil and gas properties. Beginning in 1932 percentage depletion was extended to most other minerals.

In 1950, President Truman recommended the reduction of percentage depletion to a maximum of 15 percent, but Congress failed to take action on this recommendation. Only minor changes were made until 1969 when the depletion allowance for oil and gas was reduced from 27.5 percent to 22 percent, and "excess" depletion was made subject to the minimum tax beginning in 1970.

Selected Bibliography

Agria, Susan, "Special Tax Treatment of Mineral Industries," in *The Taxation of Income from Capital*, The Brookings Institution, Washington, D.C., 1969, pp. 77–122.

U.S. Congress, Senate Committee on Interior and Insular Affairs, *An Analysis of the Federal Tax Treatment of Oil and Gas and Some Policy Alternatives*, 1974, 58 pages.

CAPITAL GAIN TREATMENT OF ROYALTIES ON COAL AND IRON ORE

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	50	20	70
1976	45	15	60
1975	40	10	50

Authorization

Section 631(c).

Description

Lessors of coal and iron ore deposits (which have been held more than 6 months prior to disposition or lease) in which they retain an economic interest may treat royalties as capital gains rather than as ordinary income. Percentage depletion is not available in such cases.

This provision cannot be used by taxpayers obtaining iron ore royalties from related individuals or corporations. No similar limitation applies to coal royalties.

Impact

The extent to which this provision results in tax saving depends on how the benefits compare with those from percentage depletion. In past years, percentage depletion on coal often has been large enough relative to profits to subject many firms to the "net income limitation" which limits percentage depletion to 50 percent of net income. This apparently has not been the case for iron ore where the percentage depletion deduction is less likely to be subject to the net income limitation.

For corporations, a percentage depletion deduction equal to 50 percent of net income reduces the effective tax rate to 24 percent (one-half of 48 percent) whereas the capital gains treatment results in a 30 percent tax rate. However, if the mine has a high basis for calculating cost depletion (which can be claimed ratably as an offset to capital gains), the election of this provision may result in a lower tax. Similarly, if the percentage depletion deduction is less than the net income limitation, capital gains treatment may be preferred.

For individuals, the tax reduction from the capital gains deduction is equivalent to that for percentage depletion when the net income limitation is applicable—taxable income is reduced by 50 percent. If the net income limitation for percentage depletion does not apply, or if the individual elects the alternative capital gain rate, capital gains treatment will be more favorable.

Note that in view of recently rising coal prices, the percentage depletion allowance will be less likely to reach the net income limitation and thus less likely to reduce tax rates by one-half. The value of newly purchased coal deposits also will be likely to rise—thus increasing the value of cost depletion. As a consequence, capital gains treatment which reduces tax rates by one-half for individuals may become relatively more valuable than percentage depletion for a larger number of individuals.[1]

Rationale

Capital gains treatment for coal royalties was adopted in the Revenue Act of 1951. The legislative history suggests it was adopted to (1) extend the same treatment to coal lessors as that allowed to timbe lessors (see p. 37), (2) provide benefits to long-term lessors with low royalty rates who were unlikely to benefit significantly from the percentage depletion deduction, and (3) to encourage the leasing and production of coal.

Capital gains treatment of iron ore royalties was added in the Revenue Act of 1964 to make the treatment of iron ore generally consistent with coal, and to encourage leasing and production of iron ore deposits in response to foreign competition.

Selected Bibliography

Agria, Susan. "Special Tax Treatment of Mineral Industries", in *The Taxation of Income from Capital,* Arnold C. Harberger and Martin J. Bailey, eds. Washington, D.C., The Brookings Institution, 1969, pp. 77–122.

U.S. Congress. House Committee on Ways and Means. *General Tax Reform.* Public Hearings. Testimony of E. V. Leisenring, National Coal Association, Part 5, March 19–20, 1973, pp. 2223–30.

---

[1] No estimated distribution of the individual tax expenditure by adjusted gross income class is provided because in 1975 when the distributions were prepared by the Treasury Department, there was so relatively little known usage of this provision by individuals that no distribution was prepared.

TIMBER: CAPITAL GAINS TREATMENT OF CERTAIN INCOME

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	65	165	230
1976	60	155	215
1975	60	145	205

Authorization

Sections 631 (a) and (b), 1221 and 1231.

Description

If a taxpayer has held standing timber or the right to cut it for more than 6 months by the first day of the taxable year, the taxpayer may elect to treat the cutting of this timber as the sale of a long-term capital asset at a price equal to its fair market value on the first day of the taxable year. Therefore, if an election is made, gain realized up to the first of the year on the cut timber is capital gain. Changes in the value of the timber after the first of the year as it is processed or manufactured will result in ordinary income or loss, and not capital gain or loss. Capital gain treatment also can apply to the sale of a stand of timber and the sale of timber as it is cut by the buyer. Timber includes ornamental evergreens which are 6 years of age when severed from the roots.

Some of a timber owner's costs which maintain or even arguably improve his trees, such as disease control and thinning costs, can be expensed currently (see Appendix A), even though their effects may continue beyond the year in which they are made, and though they are related to income which only will be recognized many years in the future. Therefore, timber ownership offers opportunities for some taxpayers to deduct current expenses associated with such ownership against ordinary income from other sources.

Impact

The capital gains treatment of the cutting and sale of timber constitutes a departure from the general rule that sale of a taxpayer's inventory yields ordinary income. However, when timber is inventory, it is usually held substantially longer than other types of inventory.

Both individual and corporate taxpayers are eligible for this treatment. The graduated structure of the individual income tax rates makes the provision more beneficial to individuals with high incomes because the value of the deduction for capital gains increases with the marginal income tax rate.

Two industries—paper and allied products and lumber and wood products—claim disproprotionately large amounts of corporate capital gains. According to 1972 Preliminary Statistics of Income for Corporations, 24 percent of taxable income of paper and allied products industries and 42 percent of taxable income of lumber and wood products were long-term capital gains. This proportion may be contrasted with a proportion of 4.4 percent for all other corporations. These two industries reported 16.9 percent of all corporate capital gains while accounting for only 2.7 percent of taxable income. Treasury Department studies published in 1969 indicate that in these industries there were five corporations which account for about one-half of the capital gains claimed, 16 firms account for about two-thirds, and 80 percent of the gains are accounted for by approximately 60 corporations.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class [1]

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	7. 3
7 to 15	12. 7
15 to 50	23. 6
50 and over	56. 4

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

The sale of a timber stand that had not been held in the course of business was long considered the sale of a capital asset. The Revenue Act of 1943 extended this capital gain treatment to all persons who cut and sell their timber and to those who lease timber stands for cutting. One reason for adopting this provision was to equalize treatment between the taxpayer who sold timber as a stand outright, and the taxpayer who cut timber for use in his business. It was also suggested that this treatment would encourage conservation of timber through selective cutting and that taxing the capital gain at ordinary rates was an unfair practice because of the comparatively long development time of timber.

Selected Bibliography

Briggs, Charles W. and Condrell, William K., *Tax Treatment of Timber*, 5th ed., Forest Industries Committee on Timber Valuation and Taxation, Washington, D.C. 1969.

Sunley, Emil M., Jr., The Federal Tax Subsidy of the Timber Industry, U.S. Congress, Joint Economic Committee, *The Economics of Federal Subsidy Programs*, Part 3—Tax Subsidies, July 15, 1972, pp. 317–42.

U.S. Congress Joint Publication of the Committee on Ways and Means and the Committee on Finance. *Tax Reform Studies and Proposals*. U.S. Treasury Department. Part 3, February 3, 1969, pp. 434–38.

POLLUTION CONTROL: 5-YEAR AMORTIZATION

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	------	15	15
1976	------	20	20
1975	------	30	30

Authorization

Section 169.

Description

In lieu of depreciation, pollution control facilities that have been certified by both State and Federal agencies may be amortized over a 5-year period using the straight line method (i.e., 20 percent of the cost may be deducted each year). This rapid amortization is currently available only with respect to treatment facilities placed in service before 1976. Certification requires that the new facility be: (1) installed in connection with a polluting facility; (2) designed specifically for pollution abatement and not for any other purposes; (3) in compliance with both the Federal Water Pollution Control Act and the Clean Air Act; and (4) a new structure. The provision applies only to tangible abatement facilities installed in connection with polluting facilities in operation before 1969.

Taxpayers may not claim an investment tax credit for property amortized under this provision.

Impact

The amortization provision has been used much less than it would otherwise have been because the investment tax credit cannot be used with amortized property. With the recent temporary increase of the investment tax credit to 10 percent (for 1975 and 1976) and the shortening of depreciation lives in 1971, the combined benefit of the credit and accelerated depreciation is usually greater than the benefit of rapid amortization. However, to the extent it is used, 5-year amortization for assets with longer useful lives benefits the taxpayer by effectively deferring current tax liability (see Appendix A).

Rather than functioning as an incentive, the 5-year amortization of pollution control facilities subsidizes corporations that must comply with Federal or State law regarding pollution. State pollution regulations vary, and there are regional cost differences for a given facility; both may account for geographical differences in the usage of the subsidy.

Rationale

Section 169 was introduced for a 5-year period to ease the financial burden of complying with environmental regulations when the Tax Reform Act of 1969 repealed the investment tax credit. When the investment tax credit was reinstated in 1971, rapid amortization was retained as an option.

Further Comment

Congress, in 1974, extended the availability of the amortization election for an additional year until December 31, 1975. Although the extension recently has expired, it still will have a revenue impact for all years in which property is amortized under its provisions. The provision may be reinstated retroactively.

Selected Bibliography

Moore, Michael L. and G. Fred Streuling, "Pollution Control Devices: Rapid Amortization Versus the Investment Tax Credit," *Taxes*, January 1974, pp. 25–30.

McDaniel, Paul R. and Alan S. Kaplinsky, "The Use of the Federal Income Tax to Combat Air and Water Pollution," *Boston College Industrial and Commercial Law Review*, February 1971, pp. 351–86.

CORPORATE SURTAX EXEMPTION

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	------	6, 185	6, 185
1976	------	5, 015	5, 015
1975	------	3, 345	3, 345

Authorization

Section 11.

Description

The permanent corporate income tax consists of a normal tax rate of 22 percent and a surtax of 26 percent for a total tax rate of 48 percent. The first $25,000 of profits are exempted from the surtax.

Temporary provisions in the Tax Reduction Act of 1975 and the Revenue Adjustment Act of 1975 reduce the normal tax rate to 20 percent on the first $25,000 of profits and 22 percent on the next $25,000 of profits, thus raising the exemption from the surtax to $50,000. These changes are presently in effect only through June 30, 1976.

Impact

The surtax exemption is available to all corporations. It tends to neutralize the tax differential between a business operating as a sole proprietorship or a partnership and a corporation by lowering the corporate tax rate on the first $25,000 ($50,000 in 1975 and part of 1976) to rates comparable to the individual rates. The exemption encourages the use of the corporate structure and allows some small corporate businesses that might otherwise operate as sole proprietorships or partnerships to provide fringe benefits. It also encourages the splitting of operations between sole proprietorships, partnerships and corporations. Most businesses are not incorporated; only about 5 percent of all businesses are affected by this provision, and not all of those receive the full tax benefit because their taxable income is less than $25,000 ($50,000 in 1975 and part of 1976).

Rationale

Since almost the earliest days of the corporate income tax, some level of profits has been exempted from the full corporate tax rate. The split between a normal tax and a surtax was not, however, fully accomplished until the Revenue Act of 1941. The surtax exemption in its present form was adopted as part of the 1950 Revenue Act. The purpose was to provide relief for small businesses. However, many large businesses fragmented their operations into numerous corporations to obtain numerous exemptions from the surtax. Some remedial steps were taken in 1963; in 1969, legislation was enacted limiting groups of corporations controlled by the same interest to a single surtax exemption.

Selected Bibliography

Capital Formation. Prepared for the use of the Committee on Ways and Means by the Staff of the Joint Committee on Internal Revenue Taxation, October 2, 1975.

Pechman, Joseph. *Federal Tax Policy.* Rev. ed. Washington, D.C.: The Brookings Institution, 1971, pp. 131–33.

DEFERRAL OF TAX ON SHIPPING COMPANIES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	--------	130	130
1976	--------	105	105
1975	--------	70	70

Authorization

46 U.S.C. Section 1177 (§ 607 of the Merchant Marine Act of 1936 as amended).

Description

United States operators of vessels operating in foreign, Great Lakes, or noncontiguous domestic trade or in the U.S. fisheries may establish a capital construction fund (CCF) in which they may deposit income earned by the vessels. Such deposits are deductible from taxable income, and income tax on earnings of deposits in the CCF is deferred.

When such tax-deferred deposits and their earnings are withdrawn from a CCF, no tax is paid if the withdrawal is used for qualifying purposes, such as to construct or acquire a new vessel or to pay off the indebtedness on a qualifying vessel. The tax basis of the vessel (usually its cost to the taxpayer) on which the operator's depreciation is computed is reduced by the amount of such withdrawal. Thus, over the life of the vessel, tax depreciation will be reduced and taxable income will be increased by the amount of such withdrawal, thereby reversing the effect of the deposit. However, since gain on the sale of the vessel and income from the operation of the replacement vessel may also be deposited into the CCF, the tax deferral may be extended indefinitely.

Only withdrawals for purposes other than for construction, acquisition, or payment on indebtedness of a qualifying vessel are taxed at the time of withdrawal, subject to an interest charge for the period during which tax was deferred.

Impact

Since 1970, over $550 million has been deposited into CCFs by 96 carriers, and almost $250 million has been withdrawn.

Rationale

The provision is designed to stimulate American shipbuilding and to recapture some of the foreign yard construction now being done for U.S. companies.

67-312—76——4

Further Comment

An important unresolved issue is whether the investment tax credit should be extended to vessels constructed with funds withdrawn from CCFs. Currently, it does not. However, a provision of the Maritime Appropriation Authorization Act of 1975, as adopted by the Senate but dropped in Conference, would have allowed the credit on such vessels.

Selected Bibliography

Jantscher, Gerald R. *Bread Upon the Waters.—Federal Aid to the Maritime Industries*, The Brookings Institution—Washington, D.C., 1975, 164 pages.

RAILROAD ROLLING STOCK: 5-YEAR AMORTIZATION

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	------	10	10
1976	------	30	30
1975	------	55	55

Authorization

Section 184.

Description

Instead of being depreciated on an accelerated basis over its normal useful life, qualified railroad rolling stock placed in service after 1968 and before 1976 may be amortized over a 5-year period using the straight line method. The use of five-year amortization for assets whose useful lives are longer benefits the taxpayer by effectively deferring current tax liability (see Appendix A). The investment tax credit is not available for property subject to this rapid amortization.

Impact

Since this tax incentive was adopted to increase the supply of railroad rolling stock, there has been a decline in both total dollar amount of railroad rolling stock purchases and use of the 5-year amortization provision. The decreasing use can be explained largely by the reinstatement of the investment tax credit in 1971, which is generally more advantageous than rapid amortization.

There are 67 Class I railroads in the United States. Since 1972, 27 of them have used the amortization provision.

Only railroad companies with taxable income benefit directly from the rapid amortization provision. Railroad companies without taxable income, in effect, sell their right to this rapid amortization to financial companies who initially acquire the rolling stock and then lease it to the railroads. As a result, some of the tax benefits from this provision accrue to lessors that are not railroad companies.

Rationale

Section 184 was adopted as part of the Tax Reform Act of 1969 when the investment tax credit was repealed. The purpose was to encourage the modernization of railroad equipment, increase railroad efficiency, reduce freight car shortages during seasonal peaks, and aid the financing of new equipment acquisitions. Although it expired December 31, 1975, a retroactive reinstatement may occur in 1976.

Selected Bibliography

Benevenutto II, Frank A., "Lease Rolling Stock and Enjoy Considerable Benefits", *Taxes*, September 1973, pp. 530–36.

BAD DEBT DEDUCTIONS OF FINANCIAL INSTITUTIONS IN EXCESS OF ACTUAL LOSSES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	------	570	570
1976	------	815	815
1975	------	880	880

Authorization

Sections 585, 593, and 596; Revenue Rulings 65–92 (C.B. 1965–1, 112), 68–630 (C.B. 1968–2, 84).

Description

In general, businesses are permitted to deduct as a current operating expense a reasonable allowance for bad debts. The allowance usually is based on the experience of prior years. However, the special formulae used by financial institutions to compute bad debt reserves permits deductions in excess of actual experience.

Prior to 1969, commercial banks were permitted a bad debt deduction of 2.4 percent of outstanding loans. The 1969 Tax Reform Act reduced this figure to 1.8 percent for years through 1975, 1.2 percent from 1976–81, and .6 percent from 1982 through 1987. After 1987, commercial banks will be limited in their loss reserve deductions to actual recent loss experience.

As an alternative to this treatment available for commercial banks, mutual savings banks and savings and loan associations have an option, under certain circumstances, to deduct a specified percentage of their taxable income. Under the provisions of the Tax Reform Act of 1969, this percentage-of-net-income allowance is being reduced from 60 to 40 percent by 1979. (The allowance for 1976 is 43 percent of taxable income.) Thereafter, the percentage allowance will remain at 40 percent. The total bad debt reserve of thrift institutions may may not exceed 6 percent of qualifying real property loans, or the percentage-of-net-income bed debt deduction will be disallowed. In addition, the annual bad debt deduction under this latter method will be reduced if the thrift institution's investments do not comprise specified proportions of certain "qualified" assets, which for "thrifts" are essentially residential mortgages.

Impact

Bad debt reserve deductions in excess of actual experience lower the effective tax rates of financial institutions, particularly thrift institutions, below the normal corporate tax rate of 48 percent. Apart from any other means of reducing tax liability, the 60 percent bad debt allowance resulted in a maximum effective tax rate for a thrift institution prior to the 1969 Tax Reform Act of 19.2 percent.[1] With full phase-in of the bad debt provisions of the 1969 Tax Act, the maximum effective tax rate of a thrift institution qualifying for the full bad debt allowance will be 28.8 percent.[2] Therefore, to the extent the bad debt deduction induced thrift institutions to hold qualified assets, such as residential mortgages, before 1969, the provisions of the 1969 Tax Act have reduced the incentive effect of this tax expenditure.

Rationale

The tax treatment of commercial banks evolved separately from that of thrift institutions. The allowance for special bad debt reserves of commercial banks was first provided by IRS ruling in 1947, when there was fear of a postwar economic downturn. It was intended to reflect the banking industry's experience during the depression period.

The special treatment of bad debt reserves for thrift institutions was added by statute in 1951. Prior to that time, savings and loan associations and mutual savings banks were exempt from taxation, in most instances because they were viewed as mutual organizations rather than corporations. Upon removal of this tax exempt status, special, and very favorable, treatment of bad debt reserves was provided for savings and loan institutions and mutual savings banks, which in effect left them virtually tax-exempt for a number of years thereafter. Some of the same factors which led to their tax exemption probably account for the special allowance for bad debts, especially in that these institutions are thought to fill an important role in providing home mortgage funds.

Selected Bibliography

U.S. Congress. Joint Publications of the Committee on Ways and Means and the Committee on Finance, *Tax Reform Studies and Proposals*, U.S. Treasury Department, Part 3; Chapter IX–D, Tax Treatment of Financial Institutions, pp. 458–75.

U.S. Treasury Department, Report on the Financial Institutions Act of 1973, A Section-by-Section Analysis, Department of the Treasury News, October 11, 1973.

---

[1] $.48-.6(.48)=.192$.

[2] $.48-.4(.48)=.288$ (without taking the minimum tax into account).

DEDUCTIBILITY OF NONBUSINESS STATE GASOLINE TAXES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	600	------	600
1976	575	------	575
1975	820	------	820

Authorization

Section 164(a)(5).

Description

State and local sales taxes on gasoline, diesel fuel, and other major fuels are deductible even if the taxes are not trade or business expenses or expenses for the production of income. Federal fuel taxes are not so treated.

Impact

This deduction benefits only taxpayers who own motor vehicles and itemize deductions rather than take the standard deduction. These tend to be middle and higher income taxpayers. Gasoline prices are reduced for taxpayers who claim the deduction, and the amount of this tax benefit per dollar of deduction increases with the tax bracket of the taxpayer.

State and local gasoline taxes are "user taxes" in the sense that the revenues they generate are generally earmarked for road maintenance and other State and local services provided highway users. The deduction allowed for these taxes is contrary to the general nondeductible treatment of user taxes. Therefore, one effect of this deduction is to shift some of the burden of these user taxes to all Federal taxpayers, regardless of the extent to which they use these local road facilities.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	3.2
7 to 15	32.3
15 to 50	60.3
50 and over	4.2

Rationale

Before 1964, a deduction for both business and nonbusiness State and local taxes was allowed in computing taxable income. The Revenue Act of 1964 eliminated the deduction for many taxes. The bill first passed by the Ways and Means Committee also eliminated the deduction for gasoline taxes, but the Senate Finance Committee restored it. It was retained by the Conference. The stated rationale for retention of the deduction was to prevent large shifts in the tax burden of individuals, to assist the States with fiscal coordination in a Federal system, and to allow the States free choice in their selection of a tax structure.

Selected Bibliography

Goode, Richard. *The Individual Income Tax*, Rev. ed. The Brookings Institution, Washington, D.C., 1976, pp. 168–71.

Davie, Bruce F. and Bruce F. Duncombe, "The Income Distribution Aspects of Energy Policies", *Studies in Energy Tax Policy*, Cambridge, Massachusetts, Ballinger Publishing Company, 1975, pp. 343–72.

Simplification of the Tax Return and Other Miscellaneous Simplification Items, Prepared for the use of the Committee on Ways and Means by the Joint Committee on Internal Revenue Taxation, October 2, 1975.

DEPRECIATION ON RENTAL HOUSING IN EXCESS OF STRAIGHT LINE, AND DEPRECIATION ON BUILDINGS (Other Than Rental Housing) IN EXCESS OF STRAIGHT LINE

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Depreciation on rental housing			Depreciation on buildings		
	Individuals	Corporations	Total	Individuals	Corporations	Total
1977	455	125	580	215	280	495
1976	430	120	550	215	275	490
1975	405	115	520	220	220	440

Authorization

Section 167(b) and (j).

Description

Businesses are allowed to recover the cost of their durable assets that wear out or become obsolete by deducting from gross income an allocable portion of the cost of the assets. Normally these depreciation deductions are spread over the useful life of the asset, and the total amount equals the asset's cost less salvage value. Taxpayers are generally offered the choice of using the straight line method (in which an equal amount of depreciation is deducted each year of the asset's life) or accelerated methods of depreciation (in which greater amounts are deducted in the early years). A taxpayer can switch from the declining balance or the sum of the years-digits methods of accelerated depreciation to straight line depreciation when it becomes advantageous to do so as the asset grows older.

The use of accelerated depreciation on structures is limited as follows:

RESIDENTIAL RENTAL UNITS

(1) New construction may be depreciated under any method allowed by the Internal Revenue Code.

(2) Used buildings having at least a 20-year life when acquired may be depreciated under the declining balance method using a rate not in excess of 125 percent of the straight line rate.

OTHER STRUCTURES

(1) New construction may be depreciated by any accelerated method which does not yield depreciation greater than the declining balance method using a rate not exceeding 150 percent of the straight line rate.

(2) Used buildings may be depreciated on the straight line method or any other reasonable method that is neither a declining balance or sum of the years digits method.

Example

Assume a used residential structure with a basis of $10,000, an expected remaining life of 25 years, and no salvage value. If the straight line method were used, the deduction would be $400 each year. Under accelerated depreciation, the first-year depreciation allowance can be computed as follows:

$$\text{Depreciation allowance} = 125\% \times 1/25 \times \$10{,}000 = \$500$$

In the second year, the depreciation allowance is computed in the same way except the original basis of $10,000 is now reduced by the amount previously depreciated. Hence, the new basis equals $9,500. The second year computation is:

$$\text{Depreciation allowance} = 125\% \times 1/25 \times \$9{,}500 = \$475$$

Thus, in each succeeding year, there is a decrease in the amount of depreciation claimed for tax purposes, and therefore an increase in tax liability compared to what it would be otherwise.

Impact

Because accelerated depreciation allows for larger deductions in the early years of the asset's life and smaller depreciation deductions in the later years, accelerated depreciation results in a deferral of tax liability. It is a tax expenditure to the extent it is faster than economic (i.e. actual) depreciation. It is widely believed to be consistent with actual experience to allow accelerated depreciation for some machinery and equipment which, in many cases, decline in value more rapidly in their early years than later years. However, similar treatment for buildings is generally believed inconsistent with their rates of economic decline in value which are generally much slower than those of machinery and equipment.

The direct benefits of accelerated depreciation for structures accrue to owners of business buildings and rental housing. The benefit is estimated as the tax saving resulting from the depreciation deductions in excess of straight line depreciation. About 77 percent of the tax saving from rental housing and 44 percent of the tax saving from nonresidential buildings accrue to individual owners. The remaining portion of each class of benefit goes to corporate owners.

Efforts to repeal accelerated depreciation for real estate have been opposed on the ground that without this treatment, real estate investments would be so unattractive relative to other forms of investment that drastic cut backs in building programs would result. On the other hand, it is argued that the tax benefits increase the production of new buildings only to the extent that demand for new buildings responds to small price changes, and that this response is relatively small. The impact of accelerated depreciation on rental housing is generally estimated to be greater than for nonresidential buildings since the demand for housing is more price elastic.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class [1]

DEPRECIATION ON RENTAL HOUSING

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	4.8
7 to 15	16.8
15 to 50	44.3
50 and over	34.1

DEPRECIATION ON BUILDINGS

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	5.0
7 to 15	17.3
15 to 50	44.1
50 and over	33.6

[1] The distribution refers to the individual tax expenditures only. The corporate tax expenditures resulting from these tax provisions is not reflected in this distribution table.

Rationale

Prior to 1954, depreciation policy had developed through administrative practices and rulings. The straight line method was favored by IRS and generally used. A ruling issued in 1946 authorized the use of the 150 percent declining balance method. Authorization for it and other accelerated depreciation methods first appeared in the statute in 1954 when the double declining balance and other methods were authorized. The discussion at that time focused primarily on whether the value of machinery and equipment declined faster in their earlier years. However, when the accelerated methods were adopted, real property was included as well even though it did not decline more rapidly in value in its first years. By the 1960s, most commentators agreed that accelerated depreciation resulted in excessive allowances for buildings. In 1964, a provision was enacted which "recaptured" accelerated depreciation as ordinary income in varying amounts when a building was sold, depending on the length of time the property was held. However, recapture was not required for straight line depreciation upon the transfer of real estate. In 1969, the current limitations were imposed and the "recapture" provision was slightly strengthened.

Further Comment

Several proposals have been made either to eliminate accelerated depreciation or to limit its benefits. One of the more generally advocated changes would limit depreciation to the equity investment in the property. Another would not allow real estate losses to offset income from other sources. There are many variations and combinations of these proposals (see for example H.R. 10612, 94th Cong., 1st Sess.).

Selected Bibliography

Surrey, Stanley S. *Pathways to Tax Reform,* Cambridge, Massachusetts, Harvard University Press, 1973. Chapter VII—Three Special Tax Expenditure Items: Support to State and Local Governments, to Philanthropy, and to Housing, pp. 209–46.

Taubman, Paul and Robert Rasche. "Subsidies, Tax Law and Real Estate Investment". U.S. Congress, Joint Economic Committee. *The Economics of Federal Subsidy Programs.* Part 3. Tax Subsidies, July 15, 1972, pp. 343–69.

U.S. Congress, House, Committee on Ways and Means, *General Tax Reform,* Panel Discussions, Part 4, "Tax Treatment of Real Estate", February 8, 1973, pp. 507–611.

U.S. Congress, House, Committee on Ways and Means, *Tax Reform. Hearings,* Part 2, Panel Nos. 1 and 2, "Tax Shelters and Minimum Tax", July 16, 1975, pp. 1403–1607.

EXPENSING OF RESEARCH AND DEVELOPMENT COSTS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	------	695	695
1976	------	660	660
1975	------	635	635

Authorization

Section 174.

Description

Taxpayers may elect to deduct costs for research and development as incurred (i.e., these costs may be "expensed") even though such costs may be associated with income that is earned over several years. The cost then is deducted before the income it earns is realized.

Impact

The mismatching of costs and income operates, as accelerated depreciation does, to defer tax liability and thereby provide the taxpayer with an interest-free loan.

For example, if Corporation Z expends $1,000 on an R&D program in a given taxable year, the entire sum is treated as a deduction from taxable income and represents a cash flow of $480 to the firm ($1,000 ×48 percent marginal tax rate=$480). The *value* of the current expense treatment, however, is the amount by which the present value of the immediate deduction exceeds the present value of periodic deductions taken over the useful life of the expenditure.

The direct beneficiaries of this provision are firms which undertake research and development. Mainly, these are large manufacturing corporations. The scanty evidence available suggests that, of the total amount claimed as research and experimental costs, about 10 percent is basic research and 90 percent is product development.

Expensing of research and development costs for tax purposes is consistent with the recent practice of a growing number of companies that expense these costs for financial accounting purposes. This treatment was approved by the Financial Accounting Standards Board in October 1974.

Rationale

This provision was added to the tax law in 1954. The general rule, then as now, was that the cost of assets that benefit future years must be capitalized and amortized over the assets' useful lives. Probably because there was difficulty in determining the useful life of such benefits, deduction was generally allowed. The treatment in a specific case was determined by the IRS administrative practice and court decisions. The purpose of the 1954 statute was to eliminate uncertainty in this area and to encourage expenditures for research and development.

Selected Bibliography

U.S. Congress, House, Committee on Ways and Means, *Tax Revision Compendium*, beginning Nov. 16, 1959, vol. 2, section G(4)— "Research and Development Expenditures," pp. 1105–23.

INVESTMENT TAX CREDIT

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	1,530	7,585	9,115
1976	1,410	6,850	8,260
1975	950	4,860	5,810

Authorization

Sections 38 and 46–50.

Description

The investment tax credit (ITC) is available to any taxpayer who invests in income-producing property which is eligible for the credit.

Eligible investment is largely limited to tangible personal property, such as machinery and equipment, that is used in the United States. Most buildings are not eligible.[1]

The amount of the credit is subtracted from tax liability calculated without the credit. The credit is currently 10 percent of the qualified investment but will revert to 7 percent (4 percent for regulated utilities) after December 31, 1976. The amount of investment that qualifies for the credit is the full purchase price of property with a life of at least 7 years, two-thirds for property with a useful life of from 5 to 7 years, one-third for property with 3- to 5-year life, and zero for property with a life of less than 3 years. Only $100,000 of investment in used property ($50,000 after December 31, 1976) qualifies in any year. The maximum credit which can be claimed in any one year is $25,000 plus 50 percent of tax liability over $25,000 (this rule is temporarily liberalized for regulated utilities). Any unused amount of the credit may be carried back 3 years and carried over 7 years (for pre-1971 carryovers a 10-year period is allowed). Use of the credit does not reduce the cost of an asset for purposes of calculating depreciation.

A corporate taxpayer may elect an additional 1 percent credit until December 31, 1976, if an amount equal to 1 percent of the qualified investment is contributed to an employee stock ownership plan.

Impact

The credit has two effects. First, it increases the recipient's cash flow. Second, it reduces the cost of capital and, therefore, can turn an unprofitable investment into a profitable one (or a profitable one into

[1] With certain exceptions, investments eligible for the credit include depreciable or amortizable property having a useful life of three years or more and include: (1) tangible personal property; (2) other tangible property (not including a building or its components) used as an integral part of (a) manufacturing, (b) extraction, (c) production, or (d) furnishing of transportation, communications, electrical energy, gas, water, or sewage disposal services; (3) elevators and escalators; and (4) research facilities and facilities for the bulk storage of fungible commodities.

a more profitable one). Assume that an investor requires a 15 percent rate of return to undertake an investment project. A machine which costs $1,000 and provides an annual return of $135 does not meet the 15 percent target. However, a 10 percent ITC reduces the net cost of the machine to $900, so the $135 annual return qualifies at the 15 percent standard (15 percent of $900=$135).

While noncorporate businesses and individual investors benefit from the credit, 80 percent of the credit accrues to corporations. Since the credit is directly related to investment in durable equipment, much of the direct benefit is concentrated in manufacturing and utilities.

According to 1972 tax data, 64 percent of the ITC is claimed by corporations with assets of $250 million or more. Two major industry categories account for 77 percent of the credit: manufacturing (44 percent) and transportation, communication, electric, gas, and sanitary services (33 percent).

For some firms, e.g., public utilities, the credit on an investment may exceed the company's tax liability. Instead of purchasing the property, the firm may find it profitable to lease the equipment from a bank that is able to obtain full benefit from the credit. Securities and Exchange Commission data indicate substantial use of the credit by banks through leasing arrangements. A refundable investment credit has been recommended by some persons for business firms that lose unused credits at the end of the carry-forward period.

Several studies have produced little evidence that suggests the past changes in the application of the credit have been effective as short-run business cycle stabilization tools. Other studies have produced conflicting evidence as to the long-run effectiveness of the credit in stimulating investment which increases the rate of capital accumulation and economic growth.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class [1]

Adjusted gross income class (thousands of dollars):	Percentage distribution
0 to 7	5.1
7 to 15	25.0
15 to 50	49.3
50 and over	20.5

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

Originally adopted as part of the Revenue Act of 1962, the purpose of the credit was to stimulate investment and economic growth. The credit was also justified as a means of increasing the ability of American firms to compete abroad and of compensating for the effect of inflation on capital replacement. The credit was modified in 1964, suspended in September 1966, restored in March 1967, repealed in April 1969, reenacted in August 1971, and temporarily liberalized in March 1975 until the end of 1976.

Selected Bibliography

Brannon, Gerard M., "The Effects of Tax Incentives for Business Investment: A Survey of the Economic Evidence," U.S. Congress, Joint Economic Committee, *The Economics of Federal Subsidy Programs*, Part 3, Tax Subsidies, 92d Congress, 2d Session, July 15, 1972, pp. 245–68.

Tax Incentives and Capital Spending, Gary Fromm, ed., the Brookings Institution, Washington, D.C., 1971, 301 pages.

U.S. Senate, Task Force on Tax Policy and Tax Expenditures and Task Force on Capital Needs and Monetary Policy, Committee on the Budget, Seminar—*Encouraging Capital Formation Through The Tax Code*, Committee Print, September 18–19, 1975.

U.S. Congress, House, Committee on Ways and Means, *General Tax Reform*, Panel Discussions, 93d Congress, 1st Session, Part 3, Tax Treatment of Capital Recovery, February 7, 1973, pp. 345–504.

U.S. Library of Congress, "An Analysis of Tax Provisions Affecting Business Investment: Depreciation and the Investment Tax Credit" by Jane Gravelle, Congressional Research Service, Multilith 74–151E, August 14, 1975.

67-312—76——5

ASSET DEPRECIATION RANGE

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	175	1,630	1,805
1976	155	1,435	1,590
1975	140	1,270	1,410

Authorization

Section 167(m); Regulation 1.167(a)–11; Rev. Proc. 72–10.

Description

The Internal Revenue Service has established useful lives for classes of depreciable assets. The asset depreciation range (ADR) system permits taxpayers to choose any useful life within a range of 20 percent more or less than the class life specified for a particular asset. If ADR is chosen, the taxpayer is not required to justify retirement and replacement policies nor to show that they are consistent with the actual useful lives of their assets.

Example

Assume that a taxpayer has a \$1,500 asset for which the class life established by the Internal Revenue Service is 10 years. Using double declining balance depreciation, without ADR, the deduction in the first year would be 200 percent×.10×\$1,500=\$300. After deduction of this depreciation charge, the adjusted basis of the asset is \$1,200 (\$1,500−\$300). In the second year, the deduction would be 200 percent×.10×\$1,200=\$240.

Under the asset depreciation range, a useful life of between 8 and 12 years may be selected. If the taxpayer chose 8 years, the first year deduction would be 200 percent×⅛×\$1,500=\$375. In the second year, the deduction would be 200 percent×⅛×\$1,125=\$281.25. Therefore, the use of ADR would result in additional deductions of \$75 the first year (\$375−300) and \$41.25 the second year (\$281.25−240.00).

Impact

The ADR system, as accelerated depreciation (see Appendix A), reduces taxes early in the life of depreciable assets and thus increases cash flow during that time. The subsidy value of ADR is the tax saving from the allowance of a tax depreciation life shorter than the guideline life of the asset. Capital intensive businesses such as manufacturing firms and utilities are necessarily the most likely to take advantage of ADR.

Securities and Exchange Commission data indicate significant use of ADR by railroads, utilities, airline companies, and truck and equipment companies. Treasury Department data indicate that the use of ADR is more probable the larger the company, and the percent of investment covered by ADR increases with the asset size of the company. Sixty percent of all business fixed investment is covered by ADR, but about 80 percent of the business fixed investment of the 360 largest corporations is covered.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class [1]

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	4.8
7 to 15	18.1
15 to 50	43.8
50 and over	33.3

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

The ADR system was established in 1971 principally to stimulate investment and economic growth by deferring taxes through the acceleration of depreciation deductions. In addition, it was asserted the system would simplify the administration of the existing depreciation rules.

Selected Bibliography

Brannon, Gerard M. "The Effects of Tax Incentives for Business Investment: A Survey of the Economic Evidence." In U.S. Congress. Joint Economic Committee, *The Economics of Federal Subsidy Programs*, Part 3, Tax Subsidies, 92d Congress, 2d Session, July 15, 1972, pp. 245–68.

U.S. Congress. House Committee on Ways and Means, *General Tax Reform*. Panel Discussions. 93rd Congress, 1st Session. Part 3—Tax Treatment of Capital Recovery, February 7, 1973, pp. 345–504.

U.S. Library of Congress. "An Analysis of Tax Provisions Affecting Business Investment: Depreciation and the Investment Tax Credit" by Jane Gravelle. Congressional Research Service, Multilith 74–151E. August 14, 1975, 50 pages.

DIVIDEND EXCLUSION

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	350	------	350
1976	335	------	335
1975	315	------	315

Authorization

Section 116.

Description

An individual may exclude up to $100 ($200 for a joint return) of dividends received from domestic corporations.

Impact

Although this provision benefits all taxpayers who receive dividend income and have tax liability, only a small percentage of total dividends is affected by the provision because of the dollar limitation. The tax saving per dollar of exclusion increases with the taxpayer's marginal tax bracket. In the aggregate, the benefits tend to accrue to middle- and high-income taxpayers because they are more likely to own stock.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	6.9
7 to 15	21.3
15 to 50	56.3
50 and over	15.6

Rationale

In 1954 a dividend exclusion of $50 and a credit of 4 percent of dividends above that amount were adopted. The stated purpose was to provide partial relief from the "double taxation" of dividends (the corporate income tax and the individual income tax on dividends) which, it was argued, hampered the ability of companies to raise capital. The exclusion was stated to be designed to afford greater relief for the low-income investor.

In 1964, although the Administration recommended repeal of both the credit and exclusion, the credit was repealed and the exclusion was doubled. The reasons offered were (1) that the provisions had not achieved their objectives, (2) the change would remove the discrimination in favor of high income taxpayers, (3) the change would encourage broader ownership of stock, and (4) the change would raise revenues that could be used to reduce the individual taxes in general.

Further Comment

As indicated above the issue that gave rise to the initial enactment of the exclusion and credit is the "double taxation" of dividends or, more generally, the burden of taxes on capital and on corporate equity capital in particular. While the exclusion survives, it does relatively little to resolve this problem because of the low dollar ceiling. Many proposals for partial and full integration of the corporate and individual income taxes have been made; some are cited in the selected bibliography.

Selected Bibliography

Goode, Richard. *The Individual Income Tax*, Rev. ed., the Brookings Institution, Washington, D.C., 1976, pp. 138–9.

The Taxation of Income from Corporate Shareholding, Symposium sponsored by the National Tax Association—Tax Institute of America and Fund for Public Policy Research, *National Tax Journal*, September 1975.

Richard and Peggy Musgrave, *Public Finance in Theory and Practice*, New York: McGraw-Hill Book Co., 1973, pp. 267–297.

CAPITAL GAINS: INDIVIDUAL (Other Than Farming and Timber)

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	6, 225	------	6, 225
1976	5, 455	------	5, 455
1975	5, 090	------	5, 090

Authorization

Sections 1201–1253.

Description

Gains on the sale of capital assets held for more than six months are subject to preferentially lower tax rates (see Appendix B). Also, gain on the sale of property used in a trade or business is treated as long term capital gain if all gains for the year on such property exceed all losses for the year on such property. Qualifying property used in a trade or business generally is depreciable property or real estate which is held more than six months, but not inventory.

Only one-half of long-term capital gains are included in income; or alternatively, on the first $50,000 of capital gain, the taxpayer may elect to pay a tax of 25 percent.

Impact

The deduction from gross income of half of capital gains results in tax rates half the normal rates. The alternative (25 percent) tax benefits only those individuals whose marginal tax rate is above 50 percent. The tax treatment of capital gains increases the after-tax earnings on assets and thereby may encourage people to invest in assets which may appreciate in value. Furthermore, the tax preference may reduce the inhibiting effects of taxation on the sale of assets.

The benefits of this provision are concentrated among high income individuals, with approximately two-thirds of the benefit received by those with adjusted gross incomes of $50,000 or more. The tax saving, per dollar of capital gain, increases with the tax bracket of the taxpayer.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	3. 1
7 to 15	7. 5
15 to 50	23. 1
50 and over	66. 3

Rationale

Although the original 1913 law taxed capital gains at ordinary rates, the 1921 law provided for an alternative flat rate tax of 12.5 percent. The intent of this treatment was to minimize the influence of the high progressive rates on market transactions. The Committee Report noted that these gains are earned over a period of years but are nevertheless taxed as a lump sum. Over the years many revisions in this treatment have been made including the temporary adoption of a sliding scale treatment (where lower rates applied the longer the asset was held). The current approach was adopted in 1942 and has remained in that form with minor revisions.

Further Comment

Many reasons have been advanced for preferential treatment of capital gains income with the major ones being: (1) capital gains are accrued over a long period of time and should not be subject to tax under progressive rates as a lump sum, (2) capital gains reflect inflation to a substantial extent and are thus not real income, and (3) because an asset owner has discretion as to when to realize gains, the existence of ordinary tax acts as a barrier to transactions in the capital market and leads to "lock-in" effects (asset owners refrain from selling because of the tax) with attendant distorting effects on savings, investment, and economic efficiency.

On the other hand, arguments have been advanced against the preferential treatment of capital gains: (1) even if capital gains were taxed as ordinary income, the advantage remains of the deferral of tax on unrealized gains, (2) inflation affects returns on assets in general, not just capital gains transactions, and assists asset purchases made with borrowed funds, (3) the "lock-in" problem might be dealt with in other ways, such as taxing gains transferred at death (thus removing the opportunity to avoid capital gains taxes entirely), and (4) the "bunching" problem can be met by a special averaging provision.

Selected Bibliography

Bailey, Martin J., "Capital Gains and Income Taxation," in *The Taxation of Income from Capital*, The Brookings Institution, Washington, D.C., pp. 11–49.

David, Martin. *Alternative Approaches to Capital Gains Taxation*, The Brookings Institution, Washington, D.C., 1968.

Martin, David and Roger Miller, "The Lifetime Distribution of Realized Capital Gains," U.S. Congress, Joint Economic Committee, *The Economics of Federal Subsidy Programs*, Part 3—Tax Subsidies, July 15, 1972, pp. 269–85.

U.S. Congress, House Committee on Ways and Means, Panel Discussions. *General Tax Reform*, Part 2—Capital Gains and Losses, February 6, 1973, pp. 245–341.

CAPITAL GAINS TREATMENT: CORPORATE
(Other Than Farming and Timber)

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	------	900	900
1976	------	760	760
1975	------	695	695

Authorization

Sections 1201, 1231, 1245, 1250, and miscellaneous others.

Description

Two main types of long-term capital gains are realized by corporations—the sale of a capital asset held for more than 6 months and, if gains for the year exceed losses for the year, the sale of property used in a trade or business for more than 6 months. (See Appendix B.) Most corporate capital gain is of the latter kind.

Long term capital gains realized by corporations generally require a dual tax computation. They are first included in income, and a tax on the total income, including the capital gain, is computed using the regular rates. In the "alternative" computation, a tax on all income other than long-term capital gain is computed at regular rates. The long term capital gain is taxed at a 30 percent rate, and the two resulting taxes are added together to yield the "alternative" tax. The lower of the tax computed the regular way or the "alternative" tax is the tax liability. Thus, a corporation must include the full amount of net long-term capital gains in taxable income but may apply the special 30 percent alternative capital gain tax rate on the gain.

Regular tax rates for corporations are 22 percent on the first $25,000 and 48 percent on any taxable income over $25,000. (Temporary provisions allow a 20-percent rate on the first $25,000, 22 percent on the next $25,000, and 48 percent on amounts over $50,000. These provisions will expire on June 30, 1976 unless renewed.)

Corporations are allowed to offset capital losses only against capital gains. Any remaining capital losses may be carried back for 3 years and forward for 5 years. Gain on most depreciable tangible personal property used in a trade or business will be treated as ordinary income to the extent it arises from depreciation that has been allowed after 1961, i.e., the depreciation is recaptured; but only a small part of depreciation on real estate is "recaptured."

Example

To illustrate, assume a corporation has, for the taxable year 1975, taxable income of $250,000, which includes net long-term capital gains of $60,000.

Tax Computed in Regular Manner:	
Taxable income	$250,000
Tax:	
(20 percent × $25,000)	5,000
(22 percent × $25,000)	5,500
(48 percent × $200,000)	96,000
Total	106,500
Alternative tax:	
Partial tax on $190,000 ($250,000–60,000):	
(20 percent × $25,000)	5,000
(22 percent × $25,000)	5,500
(48 percent × $140,000)	67,200
30 percent of $60,000	18,000
Alternative tax	95,700

The alternative tax is $10,800 less than the regular tax, and in this example, the tax expenditure is the tax savings attributable to the alternative tax computation.

Impact

Corporations with taxable income over the surtax exemption that realize income from the sale of long-term capital assets are the direct beneficiaries of this provision. Corporations that make use of the alternative tax reduce their tax liability and consequently increase their cash flow.

According to 1972 tax return data, capital gains taxed at alternative rates averaged 5 percent of taxable income for all corporations. For the following industries (excluding farming and timber) the percentage was higher than the average: metal mining; primary metals industries; banks; holding and investment companies; and real estate. Finance, insurance, and real estate combined claimed 30 percent of all corporate capital gains taxed at alternative rates.

Rationale

The Revenue Act of 1942 introduced the alternative tax for corporations at a 25-percent rate, the alternative tax rate for individuals. This tax relief was premised on the belief that many wartime sales were involuntary conversions which could not be replaced during wartime and that resulting gains should not be taxed at the greatly escalated wartime rates. The Tax Reform Act of 1969 increased the alternative rate to 30 percent. The adoption of this revision was based on several considerations, including the adoption of the limitation of the alternative capital gains tax for individuals to the first $50,000 of capital gains and the absence of the "bunching" problem (i.e., income earned over several years is recognized in a single year) that arises mostly in the individual tax because of graduated rates.

Further Comment

The effect of the difference in tax rates on ordinary income versus capital gains is not the same for corporations as for individuals for a number of reasons. Much of the capital gain results from sales in the normal course of business for a corporation. Further, the ability to exempt gains from tax by death transfers is not available. Finally, there is little "bunching" problem since the corporate rate is generally not a graduated rate.

Selected Bibliography

David, Martin. *Alternative Approaches to Capital Gains Taxation*, The Brookings Institution, Washington, D.C., 1968, 280 pages.

U.S. Congress, House Committee on Ways and Means, "Tax Treatment of Capital Gains," *Tax Revision Compendium*. Prepared for the House Committee on Ways and Means by Dan Throop Smith, 1959, Washington, D.C.: Government Printing Office, pp. 1233–1241.

EXCLUSION OF CAPITAL GAINS AT DEATH

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	7, 280	------	7, 280
1976	6, 720	------	6, 720
1975	6, 450	------	6, 450

Authorization

Sections 1001, 1002, 1014, 1221, and 1222.

Description

A capital gains tax generally is imposed on the increased value of a capital asset when the asset is sold, transferred, or exchanged. This tax, however, is not imposed on the appreciated value of such property if it is transferred as a result of the death of the owner; and any sale by the transferee is taxable only to the extent of appreciation subsequent to the transferor's death (or six months after death if the alternative valuation for estate tax is elected). Thus, appreciation during the decedent's life is not subject to the income tax.

However, the assets are subject to the Federal estate tax based upon their value at the time of death.

Impact

The exclusion of capital gains at death is most advantageous to individuals who need not dispose of their assets to achieve financial liquidity. Generally speaking, these tend to be wealthier investors. The deferral of tax on the appreciation involved combined with the exemption for the appreciation before death is a significant benefit for these investors and their heirs.

Failure to tax capital gains at death encourages "lock-in" of assets which in turn means less turnover of funds available for investment. Certain revisions in the portfolio of an investor might result in more profitable before-tax rates of return, but might not be undertaken if the resulting capital gain tax would reduce the ultimate size of the estate. The investor may, therefore, choose to retain his assets until his death, at which time portfolio revisions can be made by executors without incurring a capital gains tax liability. Taxpayers are said to be "locked into" such investments.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	6. 3
7 to 15	15. 1
15 to 50	36. 9
50 and over	41. 7

Rationale

The rationale for this exclusion is not indicated in the legislative history of any of the several interrelated applicable provisions. However, one current justification given for the exclusion is that death is considered as an inappropriate event to result in the recognition of income.

Further Comment

Taxation of capital gains at death could cause liquidity problems for some taxpayers such as owners of small farms and businesses. Most proposals for taxing capital gains at death would combine substantial averaging provisions, deferred tax payment schedules, and a substantial deductible floor in determining the amount of the gain to be taxed. Another approach would require that the decedent's tax basis be carried over to the heirs who would be taxed on appreciation if they sell the property. This solution continues the deferral and lock-in effect discussed above.

Selected Bibliography

Break, George F. and Pechman, Joseph A. *Federal Tax Reform: The Impossible Dream*, The Brookings Institution, Washington, D.C. 1975, pp. 47–8.

Pechman, Joseph A. *Federal Tax Policy*, Rev. ed., the Brookings Institution, Washington, D.C., 1971, p. 97.

U.S. Congress, House, Committee on Ways and Means, *General Tax Reform*, Panel Discussions, Part 10—Estate and Gift Tax Revision, February 27, 1973, pp. 1487–1668.

DEFERRAL OF CAPITAL GAINS ON HOME SALES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	890	------	890
1976	845	------	845
1975	805	------	805

Authorization

Section 1034.

Description

Gain from selling a residence is not taxed if the taxpayer purchases another residence with a cost at least equal to the sale price of the old residence within 18 months before or after the sale of the old residence. This treatment also applies if the seller constructs a new home of equal or greater value if construction begins within 18 months of the sale and if the taxpayer occupies the new residence within 2 years of the sale.

If the new residence costs less than the sale price of the old, the difference in price is subject to tax.

The tax basis of the new residence is reduced by the amount of the untaxed gain on the sale of the old residence. Therefore, the gain on the sale of the first home will be recognized, if at all, at the time of the sale of the second home. However, the tax may again be deferred on the gain from the sale of both homes if another home is purchased by a taxpayer meeting the requirements of section 1034. The interaction of section 1034 and section 121 which benefits those over 65 (see p. 129) will result in ultimate exemption from tax of part or all of the previously unrecognized gain if the taxpayer sells his second or subsequent home with a carryover basis after he is 65.

Impact

As with any tax deferral, the taxpayer receives the equivalent of an interest-free loan. This provision benefits primarily middle and upper income taxpayers (about four-fifths of the benefit accrues to those in the $7,000–$50,000 adjusted gross income (AGI) class). This subsidy facilitates the ownership of increasingly expensive homes, much of the increase in which in many cases is attributable to inflation.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	6.7
7 to 15	23.9
15 to 50	56.9
50 and over	12.5

Rationale

The provision was adopted in 1951 to relieve financial hardship when a personal residence is sold, particularly when the sale is necessitated by such circumstances as an increase in family size or change in the place of employment. The Senate Committee Report noted that sales in these circumstances are particularly numerous in periods of rapid change such as mobilization or reconversion (presumably referring to wartime conditions).

Further Comment

Many have questioned the taxation of any gain from the sale of a personal residence, particularly since the tax law does not allow the deduction of personal capital losses and because the purchase of a personal residence is less of a profit motivated investment than many other types of investment. On the other hand, tax deferral of gain from home sales does favor investment in homes as compared to other types of investment and, along with other features of the tax law, contributes to the general favorable treatment afforded homeowners in the tax law.

Selected Bibliography

U.S. Congress, House, Committee on Ways and Means, Panel Discussions. *General Tax Reform*, Part 2—Capital Gains and Losses (note, particularly, testimony of Kenneth B. Sanden, p. 254).

DEDUCTIBILITY OF MORTGAGE INTEREST AND PROPERTY TAXES ON OWNER-OCCUPIED PROPERTY

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals		Corporations	Total
	Property taxes	Mortgage interest		
1977	3, 825	4, 710	------	8, 535
1976	3, 690	4, 545	------	8, 235
1975	4, 510	5, 405	------	9, 915

Authorization

Sections 163 and 164.

Description

A taxpayer may take an itemized deduction for mortgage interest and property tax paid on his owner-occupied home.

Impact

The deduction of nonbusiness mortgage interest and property taxes allows homeowners to reduce their housing costs; tenants have no such opportunity because they cannot deduct rental payments.[1] High income individuals receive greater proportional benefits than low income persons, not only because of higher marginal tax rates, but also because higher income taxpayers are more likely to own one or more homes (and higher income people are likely to own higher priced homes with larger mortgages and higher property taxes) and to itemize deductions.

These provisions encourage home ownership by reducing its cost in comparison to renting. Some observers believe that these deductions, together with other favorable income tax provisions accorded to homeowners, have been an important factor in the rapid rise of homeownership since World War II. Other observers suggest that the housing market has adjusted for these deductions and that home price increases have compensated for the tax benefit.

[1] In contrast to the rental income paid to a landlord by a tenant, the rental value of an owner-occupied home is not imputed—i.e. not included—in the income of the owner. Such income thus is tax exempt, but the mortgage interest and property tax expense of earning it is allowed as a deduction from other taxable income. These deductions favor investment in owner occupied homes over investments in residential rental property or other assets such as securities.

67–312—76——6

To the extent that the deductibility of State and local property taxes allows these taxes to be higher than they would otherwise be, the provision has an effect similar to a revenue sharing program.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class	Percentage distribution	
	Property taxes	Mortgage interest
0 to $7,000	2.2	1.3
$7,000 to $15,000	19.8	23.6
$15,000 to $50,000	62.7	65.9
$50,000 and over	15.3	9.1

Rationale

Generally, the deductibility of interest and of State and local taxes has been a characteristic of the Federal income tax structure since the Civil War income tax. An explicit rationale was never advanced, but close examination of the legislative histories suggests that these payments were viewed as reductions of income. No distinction was made between business and nonbusiness expenses. There is no evidence that deductibility of these items was originally intended to encourage home ownership or to subsidize the housing industry, which is the present justification offered for this treatment.

The Code was revised in 1964 to specify the types of nonbusiness taxes which could be deducted. The treatment for property taxes was retained because removing the deduction would have precipitated a large shift in overall tax burdens.

Selected Bibliography

Goode, Richard. *The Individual Income Tax,* Rev. Ed., The Brookings Institution, Washington, D.C., 1976, pp. 117–25.

Aaron, Henry. *Who Pays the Property Tax,* The Brookings Institution, Washington, D.C., 1975.

"Federal Housing Subsidies," U.S. Congress, Joint Economic Committee, *The Economics of Federal Subsidy Programs,* Part 5—Housing Subsidies, October 9, 1972, pp. 571–96.

Laidler, David, "Income Tax Incentives for Owner-Occupied Homes," *Taxation of Income From Capital.* Bailey and Harberger, eds. Washington, D.C., The Brookings Institution, 1969, pp. 50–76.

EXEMPTION OF CREDIT UNIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	------	135	135
1976	------	125	125
1975	------	115	115

Authorization

Section 501(c)(14).

Description

Credit unions without capital stock, and organized and operated for mutual purposes and without profit, are not subject to Federal income tax.

Impact

Because their income is exempt from the income tax, credit unions are treated more favorably than are competing financial institutions whose income is taxed. On the other hand, credit unions are subject to certain special constraints not required of their competitors, such as limits on the interest rate charged on loans, on the duration of loans, and on the types of investments that are allowed. In addition, credit unions may lend only to members; however, only a small deposit may be required for membership that qualifies the member for a loan greatly in excess of the deposit.

Rationale

Credit unions have never been subject to the Federal income tax. Initially, they were included in the provision that exempted domestic building and loan associations—whose business was at one time confined to lending to members—and nonprofit cooperative banks operated for mutual purposes. The exemption for mutual banks and savings and loan institutions was removed in 1951, but credit unions retained their exemption. No specific reason was given for continuing the exemption of credit unions.

Selected Bibliography

Gelb, Bernard A., *Tax Exempt Business Enterprise,* The Conference Board, New York, 1971.

U.S. Congress, House, Committee on Ways and Means, "Some Considerations on the Taxation of Credit Unions" Prepared by John T. Crotean for the House Committee on Ways and Means, *Tax Revision Compendium,* Vol. 3, 1959, pp. 1833–66.

DEDUCTIBILITY OF INTEREST ON CONSUMER CREDIT

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	1, 075	------	1, 075
1976	1, 040	------	1, 040
1975	1, 185	------	1, 185

Authorization

Section 163.

Description

A taxpayer may take an itemized deduction for interest paid or accrued on nonbusiness indebtedness (for example, personal and auto loans and credit account purchases).

Impact

This provision reduces net interest charges and thereby reduces the price of consumer purchases financed by debt. If the purchase is an asset that earns income, that is then subject to tax (e.g., borrowing to purchase mutual fund shares), the interest charge is an expense of earning income and it would cusomarily be deductible as an investment expense. For other items the interest deduction acts as a subsidy and thus encourages their purchase, financed by borrowing. Because higher income taxpayers are more likely to itemize deductions, they are more likely to benefit from this provision than are taxpayers in lower brackets.

Under 1954 legislation, the deduction for carrying charges on most consumer credit (unless explicitly denominated "interest") was limited to about 6 percent on the declining balance of consumer debt. In more recent years, bank charge cards have proliferated, and the Internal Revenue Service has ruled that charges on those cards generally can be fully deducted as interest. On the other hand, purchases under deferred payment contracts usually remain subject to the limitation already mentioned. Thus, the theoretical treatment of bank charge cards differs substantially from deferred payment sales where carrying charges are often not called "interest." Whether this distinction is observed in practice is unknown.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	Percentage distribution
0 to 7	1.4
7 to 15	23.7
15 to 50	66.0
50 and over	9.0

Rationale

While the 1862 income tax statute did not contain a special provision for the deduction of interest, it was allowed. When the income tax was reinstituted in 1913, a special provision allowing the deduction of interest was included, apparently because of concern that interest might not be treated as a business expense and deducted under the general business expense provision. At that time, no distinction was drawn between business and nonbusiness interest expense, presumably because the latter constituted a very small proportion of total interest expense. However, today the nonbusiness interest cost is perceived as a consumption item and hence different from business interest.

Selected Bibliography

Kahn, C. Harry. *Personal Deductions in the Federal Income Tax*, Princeton, Princeton University Press, 1960, pp. 109–24.

CREDIT FOR PURCHASING NEW HOME

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	100	------	100
1976	625	------	625
1975	------	------	------

Authorization

Section 44.

Description

A credit against tax liability is allowed for 5 percent of the purchase price of a "new principal residence" purchased after March 12, 1975, and before January 1, 1976. The maximum amount of the credit is $2,000 or tax liability for 1975, whichever is less. Only houses on which construction began before March 26, 1975, are eligible. Single family houses, condominium and cooperative units, and mobile homes all qualify. The purchase price may be no higher than it was on February 28, 1975.

Example

A taxpayer who purchases a new home in July 1975 costing $40,000 or more may claim a credit of $2,000 against his income tax for 1975. If his tax for 1975 is $3,000, the $2,000 credit can be subtracted directly from the tax and the tax due will be only $1,000. If the purchase price [1] of the house is less than $40,000, the credit will be 5 percent of the purchase price. The amount of the credit may not exceed tax liability. Thus, if a taxpayer earns a credit of $2,000 but owes a tax of only $1,500, the credit will be $1,500.

Impact

The distribution of the tax savings by income class will not be known until 1975 tax returns are filed and analyzed. While some portion of the benefit from the credit will be received by home sellers who did not reduce their asking price as much as they would have otherwise, home buyers—particularly those with taxable income above $20,000—will also benefit. Some families who qualify will not receive the full amount of the credit because their tax liability will be less than the credit. For example, for a family of four, tax liability begins only when income reaches nearly $6,000, and tax liability does not amount to $2,000 until income is about $17,500.

---

[1] In calculating the amount of the credit, the purchase price must be reduced by the amount of gain on the sale of a previous residence unless tax is paid on the gain.

The impact of the credit on housing and on the economy is difficult to measure because it cannot be isolated from the other factors at work in the housing industry at the same time. Some initial evidence indicates the credit had little or no favorable impact on the inventory of unsold new houses, new home sales, housing starts, or construction industry employment.[1] On the other hand, evidence cited by the home building industry indicates the credit did have an impact on home sales.

Rationale

The home purchase tax credit was enacted as part of the Tax Reduction Act of 1975. Its purpose was described as primarily to reduce the existing inventory of unsold new homes.

Selected Bibliography

U.S. Congress, Senate, Senate Report No. 94–36, March 17, 1975, p. 12.

U.S. Congressional Budget Office, "An Analysis of the Impact of the $2,000 Home Purchase Tax Credit" (processed November 20, 1975).

---

[1] Federal Home Loan Bank Board Newsletter, Oct. 14, 1975; Secretary of Housing and Urban Development Carla Hills, testimony before the Senate Committee on Banking, Housing and Urban Affairs, Nov. 5, 1975.

HOUSING REHABILITATION: 5-YEAR AMORTIZATION

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	40	25	65
1976	55	35	90
1975	65	40	105

Authorization

Section 167(k).

Description

In lieu of depreciation, certain expenditures incurred to rehabilitate low or moderate income rental housing may be amortized over five years using the straight line method and no salvage value. This rapid amortization is permitted only with respect to expenditures incurred after July 24, 1969, and before 1976, or, if made under a pre-1975 binding contract, before 1978. Moreover, the write-off is available only where during a period of two consecutive years, expenditures exceed $3,000 per unit, and applies only to expenditures not in excess of $15,000 per rental unit. The use of 5-year amortization for assets whose useful lives are longer benefits the taxpayer by effectively deferring current tax liability (see Appendix A).

Example

Assume a taxpayer spends $10,000 on structural rehabilitation of a low or moderate income rental housing with a useful life of 20 years. Without the amortization provision (using the double declining balance method of computing depreciation), his deduction in the first year would be:

$$200 \text{ percent} \times \tfrac{1}{20} \times \$10{,}000 = \$1{,}000$$

In the second year his depreciation would be:

$$200 \text{ percent} \times \tfrac{1}{20} \times \$9{,}000 = \$900$$

The deductions for depreciation would continue in smaller amounts over the remaining life of the asset.

With five-year amortization, one-fifth of the amount ($2,000) is deducted each year for 5 years. Afterwards no additional deduction for amortization or depreciation may be taken.

Impact

The tax benefit accrues to investors in projects to rehabilitate low and moderate income housing; about 60 percent of the tax relief goes to individual taxpayers. Even though the properties in question may not be currently earning income, the rapid amortization may be deducted against other income from housing investments and may provide a tax shelter for totally unrelated income. Low income renters benefit only to the extent that rehabilitated units rent for less than new units of comparable quality, or to the extent that more units are rehabilitated than would be otherwise. The very small amount of evidence available does not indicate a flow through of tax benefits to the renters.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class [1]

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	4.0
7 to 15	4.0
15 to 50	16.0
50 and over	76.0

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from this tax provision is not reflected in this distribution table.

Rationale

This provision was adopted as part of the Tax Reform Act of 1969 as a temporary provision to stimulate rehabilitation of low and moderate income housing. It was subsequently extended for 1 year by P.L. 93–625 (January 3, 1975). Although it expired December 31, 1975, a retroactive reinstatement may be passed in 1976.

Selected Bibliography

Heinberg, John D. and Emil M. Sunley, Jr., "Tax Incentives for Rehabilitating Rental Housing," in *Housing 1971–1972*. AMS Press (1974). Reprinted as Urban Institute Reprint, URI–10122.

McDaniel, Paul R. "Tax Shelters and Tax Policy." *National Tax Journal*, Vol. XXVI, No. 3, September 1973, pp. 353–88.

Surrey, Stanley S. *Pathways to Tax Reform*. Cambridge, Massachusetts, Harvard University Press, 1973. Chapter VII—Three Special Tax Expenditure Items: Support to State and Local Governments, to Philanthropy, and to Housing, pp. 209–46.

U.S. Congress. House Committee on Ways and Means. *General Tax Reform*, Panel Discussions. 93rd Congress, 1st Session. Part 4—Tax Treatment of Real Estate, February 8, 1973 and Part 6—Minimum Tax and Tax Shelter Devices, February 20, 1973, pp. 507–611 and 697–912.

U.S. Congress, House Committee on Ways and Means, *Tax Reform*: Hearings, Part 2. Panels Nos. 1 and 2—Tax Shelters and Minimum Tax, July 16, 1975, pp. 1403–1607.

FIVE YEAR AMORTIZATION OF CHILD CARE FACILITIES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	------	5	5
1976	------	5	5
1975	------	5	5

Authorization

Section 188.

Description

In lieu of depreciation, an employer may amortize, on a straight line basis over 60 months, capital expenditures to acquire, construct, reconstruct, or rehabilitate property that qualifies as an employee child care facility. The types of facilities which qualify are described generally by regulation as those where children of employees receive personal care, protection, and supervision in the absence of their parents. Section 188 applies only to expenditures made after December 31, 1971, and prior to January 1, 1977. The investment credit cannot be claimed for property subject to this amortization.

Impact

As with any rapid amortization provision, the taxpayer is allowed to defer some current tax liability (see Appendix A). The effect of this provision in increasing the number of child care facilities is unclear.

Rationale

This tax benefit, adopted in 1971, is intended to encourage employers to provide more child care facilities for children of single parents and working mothers.

Selected Bibliography

U.S. Congress. Joint Committee on Internal Revenue Taxation. *General Explanation of the Revenue Act of 1971*, H.R. 10947, 92d Congress, P.L. 92–178, December 15, 1972, Washington, D.C., U.S. Government Printing Office, 1972, pp. 62–4.

U.S. Department of Labor, Women's Bureau, *Day Care Services: Industry's Involvement*, Bulletin 296, Washington, D.C., U.S. Government Printing Office, 1971, p. 33.

Maymi, Carmen R. "Working Mothers—Their Child Care Needs." Address delivered at meeting of the Chicago Community Coordinated Child Care Committee. Chicago, Illinois, November 2, 1974.

EXCLUSION OF SCHOLARSHIPS AND FELLOWSHIPS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	220	----------	220
1976	210	----------	210
1975	200	----------	200

Authorization

Section 117.

Description

Generally, individuals may exclude from taxable income amounts received as scholarships or fellowships. The exclusion includes amounts received to cover such incidental expenses as travel, research, clerical assistance, or equipment, but does not apply to any amount received as payment for teaching, research, or similar services. The amount that degree candidates may exclude is unlimited. Scholarships and fellowships for nondegree candidates may be excluded only if the grantors meet certain requirements; further, the amount that they may exclude is limited.

Impact

The value of the tax benefit received by each recipient of a tax exempt scholarship or fellowship grant is small in many cases because grants are of modest amounts and the recipients have little or no tax liability.

However, the amount of the tax benefit increases with the individual's tax bracket, and therefore, increases with the existence of other income such as a spouse's earnings. Furthermore, university professors often convert sabbatical pay into tax free fellowships.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	47.7
7 to 15	36.9
15 to 50	15.4
50 and over	0

Rationale

Prior to the Internal Revenue Code of 1954, scholarships were included in income unless the taxpayer could show that the grant was a gift. This treatment was considered to lack uniformity. The ostensible purpose of the exclusion was to make treatment of taxpayers consistent and uniform. The only amendment to this section, made in 1961 (P.L. 87-256), expanded the category of qualifying grantors of nondegree candidates' scholarships and fellowship grants.

Selected Bibliography

U.S. Congress, House Committee on Ways and Means. Internal Revenue Code of 1954, *Report to Accompany H.R. 8300, A Bill to Revise the Internal Revenue Laws of the United States*, Washington, D.C., U.S. Government Printing Office, 1954, pp. 16–17, A37–A38 (83rd Congress, 2nd Session, House Report No. 1337).

U.S. Congress, Senate Committee on Finance. *Internal Revenue Code of 1954, Report to Accompany H.R. 8300, A Bill to Revise the Internal Revenue Laws of the United States*, Washington, D.C., U.S. Government Printing Office, 1954, pp. 17–18, 188–90 (83rd Congress, 2nd Session, Senate Report No. 1622).

PARENTAL PERSONAL EXEMPTION FOR STUDENT AGE 19 OR OVER

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	715	----------	715
1976	690	----------	690
1975	670	----------	670

Authorization

Section 151(e).

Description

A taxpayer is allowed to deduct $750 as an exemption for each dependent. A person with gross income in excess of $750 may not be claimed as a dependent unless that person is the child of the taxpayer and is either (a) less than 19 years of age or (b) a full-time student. Unless support is provided by several taxpayers, a person is a dependent only if the taxpayer claiming him as a dependent provided more than one-half of the person's support.

Impact

This provision benefits families with tax liability and with children who are students and have earnings. The value of each $750 personal exemption deduction is $525 for families with the highest marginal tax rate of 70 percent and $150 for families taxed at the median marginal rate of 20 percent. No relief is available to the parents of students who provide more than one-half of their own support. Therefore, parents are aided by this dependency exemption if their student-children do not rely on their earnings or other income to provide a majority of their support.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	7. 0
7 to 15	47. 6
15 to 50	31. 0
50 and over	14. 4

Rationale

A personal exemption for dependents was first provided by the Revenue Act of 1918, apparently to provide some tax relief for parents supporting young children or students. The definition of a dependent was revised over the years and a gross income test was added in 1944. The 1954 revision of the Internal Revenue Code eliminated the gross income test for dependent children under the age of 19 and dependent children of any age who were students. Except for increases in the amount of the exemption to $750, this provision has been unchanged since 1954.

Selected Bibliography

U.S. Congress, House, Committee on Ways and Means. *Internal Revenue Code of 1954, Report to Accompany H.R. 8300, A Bill to Revise the Internal Revenue Laws of the United States*, Washington, D.C., U.S. Government Printing Office, 1954, pp. 18–9, A40–A41, *Tax Revision Compendium.* Papers on Broadening the Tax Base, November 16, 1959, vol. 1, Washington, D.C, U.S. Government Printing Office, pp. 533–4.

Groves, Harold M. *Federal Tax Treatment of the Family*, The Brookings Institution, Washington, D.C., pp. 39–43.

Seltzer, Lawrence H. *The Personal Exemption in the Income Tax*, National Bureau of Economic Research, New York, 1968, pp. 113–20.

DEDUCTIBILITY OF CHARITABLE CONTRIBUTIONS

(1) Educational Institutions

(2) Other Than Educational Institutions

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals		Corporations		Total
	Educational	Other	Educational	Other	
1977	500	3,955	280	525	5,260
1976	450	3,820	215	395	4,880
1975	440	4,385	205	385	5,415

Authorization

Sections 170 and 642(c).

Description

Subject to certain limitations, charitable contributions may be deducted by individuals, corporations, and estates and trusts.

The contributions must be made to specific types of organizations including charitable, religious, educational and scientific organizations, and Federal, State, and local governments.

Individuals may itemize and deduct qualified contributions amounting up to 50 percent of their adjusted gross income (AGI); however, the deduction for gifts of appreciated property is limited to 30 percent of AGI. In the case of a corporation, the limit is 5 percent of taxable income (with some adjustments).

Impact

The deduction for charitable contributions reduces tax liability and thus makes the net cost of contributing less than the amount of the gift. In effect, the Federal Government provides the donee with a matching grant which, per dollar of contribution, increases in value with the donor's tax bracket. Thus, a taxpayer in the 70 percent bracket who itemizes deductions can contribute $100 to a charitable organization at a net cost of $30 while one in the 20 percent bracket can contribute the same amount at a net cost of $80. An individual who takes the standard deduction or a non-taxpayer receives no benefit from the provision.

67-312—76——7

Types of contributions may vary substantially among income classes. Contributions to religious organizations are far more concentrated at the lower end of the income scale than contributions to hospitals, the arts, and educational institutions, with contributions to other types of organizations falling between these levels. However, the volume of donations to religious organizations is greater than to all other organizations as a group.

Organizations that receive the contributions (and their clients) benefit from this provision to the extent it increases charitable giving. Empirical studies have not reached a consensus as to how much the deduction encourages charitable contributions and how the deduction affects the composition of contributions. Tentative conclusions are that the deduction increases charitable giving by more than the forgone Treasury revenue, and that it favors educational contributions relatively more than would a tax credit or a matching grant program outside the tax system.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class [1]

Adjusted gross income class	Percentage distributions	
	Educational	Other
0 to $7,000	0.3	2.3
$7,000 to $15,000	1.4	16.6
$15,000 to $50,000	23.7	47.1
$50,000 and over	74.6	34.0

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

This deduction was added on the Senate floor in 1917. Senator Hollis, the sponsor, argued that the war and high wartime tax rates had an adverse impact on the flow of funds to charitable organizations. He preferred a tax deduction to a direct Government subsidy. The deduction was extended to estates and trusts in 1918 and to corporations in 1935.

Selected Bibliography

Bittker, Borris, "Charitable Contributions: Tax Deductions or Matching Grants?" *28 Tax Law Review 37* (1972).

Feldstein, Martin, "The Income Tax and Charitable Contributions: Part I—Aggregate and Distributional Effects", *National Tax Journal,* March 1975, pp. 81–11; "The Income Tax and Charitable Contributions: Part II—The Impact on Religious, Educational, and Other Organizations", *National Tax Journal,* June 1975, pp. 209–226.

McDaniel, Paul R., "Federal Matching Grants for Charitable Contributions: A Substitute For The Income Tax Deduction", *27 Tax Law Review 377* (1972).

Surrey, Stanley R., *Pathways to Tax Reform,* Chapter VII—Three Special Tax Expenditure Items: Support to State and Local Governments, to Philanthropy, and to Housing", Cambridge, Massachusetts, Harvard University Press, 1973, pp. 209–46.

National Tax Association—Tax Institute of America. *Tax Impacts on Philanthropy—a Symposium.* Washington, D.C., December 2–3, 1972. Princeton: NTA–TIA and Fund for Public Policy Research, 1972.

Commission on Private Philanthropy and Public Needs, John H. Filer, Chairman, *Giving in America: Toward a Stronger Voluntary Sector*, 1975.

DEDUCTIBILITY OF CHILD AND DEPENDENT CARE SERVICES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	420	--------	420
1976	330	--------	330
1975	295	--------	295

Authorization

Section 214.

Description

A taxpayer may deduct certain expenses to care for a dependent child (under age 15), disabled dependent or spouse, or for household services when the taxpayer maintains a household for them. Deductible expenses are those incurred to enable the taxpayer to be gainfully employed full-time. The services must be rendered in the home, except for dependent children.

The deduction generally is limited to $400 a month. However, the monthly deduction limit for services rendered outside the home is $200 for one child, $300 for two children, and $400 for three or more children.

To claim the deduction, a husband and wife both must be employed full time unless one spouse is disabled.

For 1976 and later years, the deduction is reduced by $1.00 for each dollar of adjusted gross income (AGI) over $35,000; thus, the maximum deduction is entirely phased out when AGI equals $44,600.

Impact

Only taxpayers who itemize deductions may take advantage of this provision. Thus, taxpayers with moderate child care expenses and low levels of income are not likely to receive much tax relief from this provision, while high income taxpayers receive no relief from the provision at all because of the phase-out.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	3. 5
7 to 15	50. 4
15 to 50	46. 1
50 and over	0

Rationale

The deduction for child and dependent care services originated in 1954. The allowance was limited to $600 per year and was phased out for those with family income between $4,500 and $5,100. The intent of the provision was to provide for the deduction of expenses comparable to an employee's business expenses in cases where taxpayers must incur such expenses.

The provision was made more generous in 1964 and modified in 1971. The Tax Reduction Act of 1975 substantially increased the income limits.

Several new justifications were specified in 1971 including encouraging the hiring of domestic workers, encouraging the care of incapacitated persons at home rather than in institutions, providing relief to middle income taxpayers as well as low income taxpayers, and providing relief for employment-related expenses of household services as well as for dependent care. Thus, there was a departure from earlier intent that only "essential" expenditures for such services should be deductible.

Further Comment

Numerous proposals have been made to treat expenses for household service and dependent care as business rather than personal expense and, thus, eliminate the necessity to itemize the deduction in order to benefit. The substitution of a credit for a deduction was adopted by the House in H.R. 10612 in December 1975.

Selected Bibliography

Greenwald, Carol S. and Linda G. Martin, *Broadening the Child Care Deduction: How Much Will It Cost?* Federal Reserve Bank of Boston, September/October 1974, pp. 22–30.

Keane, John B., "Federal Income Tax Treatment of Child Care Expenses," *Harvard Journal of Legislation*, December 1972, pp. 1–40.

Klein, William A., "Tax Deductions for Family Care Expenses," *Boston College Industrial and Commercial Law Review*, May 1973, pp. 917–41.

CREDIT FOR EMPLOYING PUBLIC ASSISTANCE RECIPIENTS UNDER WORK INCENTIVE (WIN) PROGRAM

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	--------	10	10
1976	--------	10	10
1975	--------	10	10

Authorization

Sections 40, 50A, and 50B.

Description

Taxpayers are allowed a credit against their tax liability equal to 20 percent of the wages paid or incurred with respect to Federal welfare recipients in the aid to dependent children (AFDC) program who are hired under the Work Incentive Program (WIN).

The WIN credit may not exceed $25,000 plus 50 percent of any tax liability over $25,000 in any one taxable year. Excess credits may be applied to past and future tax liability; the credit may be carried back 3 years and forward 7 years.

In 1975 the credit was temporarily expanded to apply to wages paid AFDC recipients who were not in the WIN program for services rendered to employees before July 1, 1976.

Impact

The WIN tax credit operates as a wage subsidy by providing tax relief for employers who hire eligible employees. Participating employees benefit, as does the general taxpayer to the extent that employment and earnings are increased by the program and welfare payments are reduced. But, other things being eoual, individuals not enrolled in this program may be at a disadvantage when seeking employment.

Income tax data for 1972 indicate that slightly more than half of the corporate claims for the credit were by corporations with assets of $250 million or more; about 60 percent was claimed by the manufacturing sector (nearly 25 percent by the auto industry), followed by about 15 percent in wholesale and retail trade.

Rationale

WIN was created by Congress in 1967 to encourage private employers to hire and train welfare recipients. The WIN tax credit was created by the Revenue Act of 1971 to further encourage employers to hire welfare recipients and was extended in 1975 temporarily to AFDC welfare payment recipients, regardless of participation in the WIN program, again to encourage employment practices that would reduce welfare payments.

Selected Bibliography

U.S. Congress, The Joint Committee on Internal Revenue Taxation *General Explanation of the Revenue Act of 1971*, H.R. 10947, 92d Congress, Public Law 92–178, December 15, 1972.

EXCLUSION OF EMPLOYER CONTRIBUTIONS TO MEDICAL INSURANCE PREMIUMS AND MEDICAL CARE

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	4, 225	------	4, 225
1976	3, 665	------	3, 665
1975	3, 275	------	3, 275

Authorization

Section 106.

Description

Employees do not pay tax on their employers' contributions to accident and health plans which compensate them for sickness and injury.

Impact

The exclusion for the employer's contribution to employee health insurance plans benefits all taxpayers who participate in a plan. Because of the exemption, employers can provide the insurance coverage at less cost than they would have to pay in taxable wages for employees to purchase an equal amount of insurance. Thus, in effect, the provision reduces the employee's net after-tax price of obtaining health insurance and health services. The exclusion is worth more the higher the taxpayer's marginal tax rate.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	7. 8
7 to 15	32. 2
15 to 50	50. 4
50 and over	9. 6

Rationale

Prior to the adoption of the Internal Revenue Code of 1954, amounts paid by employers for group employee insurance were excluded from gross income of the employee. However, amounts paid for individual policies were included. Section 106 equalized the tax treatment of contributions to the various funds by exempting them all.

While the objective of the original group policy exemption is not clear, the current treatment is justified as indirect Federal assistance to help pay for the health insurance of taxpayers.

Selected Bibliography

Feldstein, Martin and Elizabeth Allison, "The Tax Subsidies of Private Health Insurance Distribution, Revenue Loss and Effect," in U.S. Congress, Joint Economic Committee, *The Economics of Federal Subsidy Programs,* Part 8—Selected Subsidies, July 29, 1974, pp. 977–94.

Davis, Karen. *National Health Insurance: Benefits, Costs, and Consequences,* The Brookings Institution, Washington, D.C., 1975, 182 pages.

Goode, Richard. *The Individual Income Tax,* Rev. ed., The Brookings Institution, Washington, D.C., 1976, pp. 156–60.

DEDUCTIBILITY OF MEDICAL EXPENSES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	2, 095	------	2, 095
1976	2, 020	------	2, 020
1975	2, 315	------	2, 315

Authorization

Section 213.

Description

Medical expenses paid by an individual may be itemized and deducted from income to the extent they exceed 3 percent of adjusted gross income (AGI). In computing medical expenses, amounts paid for medicine and drugs may be taken into account only to the extent they exceed 1 percent of AGI. In addition, the 3 percent floor notwithstanding, an amount—not in excess of $150 per year—equal to one-half of medical insurance premiums for the year may be deducted.

Impact

For taxpayers who itemize their deductions, this provision reduces the net (after-tax) price of health insurance and health services. The deduction is worth more the higher the taxpayer's marginal tax rate.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	7. 2
7 to 15	35. 1
15 to 50	47. 5
50 and over	10. 2

Rationale

Health costs in excess of a given floor were first allowed as a deduction in 1942 in order to maintain high standards of public health and to ease the burden of high wartime tax rates. Originally, the deduction was allowed only to the extent that medical expenses exceeded 5 percent of AGI (considered to be the average family medical expense level), and was subject to a $2,500 maximum. In 1951, the floor was removed for taxpayers 65 or over. In 1954, when the Internal Revenue

Code was substantially revised, the percentage of AGI was reduced to 3 percent and the 1 percent floor was imposed on drugs and medicines. The dollar ceiling was increased several times until it was finally eliminated in 1965. In that year, the aged were made subject to the floor and deductions for health insurance premiums were allowed without a floor. Since insurance premiums help to even out health expenditures and make it less likely that such expenses can be deducted, it was reasoned that half the cost of insurance premiums should be outside the floor to prevent the tax system from discouraging the purchase of health insurance.

Further Comment

Tax deductions and exclusions related to health care may affect the pattern of purchase of medical services, particularly the purchase of medical care through insurance. While tax subsidies for medical care provide financial relief for some taxpayers who itemize unusually large medical expenses (the relief being greater the higher the tax bracket), at the same time, these subsidies may encourage the purchases of medical services and thus contribute to the bidding up of prices for those services. However, alternative programs to provide national health insurance also may result in bidding up the price of these services.

Selected Bibliography

Feldstein, Martin and Elizabeth Allison, "The Tax Subsidies of Private Health Insurance Distribution, Revenue Loss and Effect," in U.S. Congress, Joint Economic Committee, *The Economics of Federal Subsidy Programs*, Part 8—Selected Subsidies, July 29, 1974, pp. 977–94.

Davis, Karen. *National Health Insurance: Benefits, Costs, and Consequences*, The Brookings Institution, Washington, D.C., 1975, 182 pages.

Goode, Richard. *The Individual Income Tax*, Rev. ed. The Brookings Institution, Washington, D.C., 1976, pp. 156–60.

Mitchell, B. M. and R. J. Vogel, *Health and Taxes: An Assessment of the Medical Deduction*, R–1222–OEO, The Rand Corporation, Santa Monica, Calif., August, 1973.

EXCLUSION OF SOCIAL SECURITY BENEFITS

Disability Insurance Benefits, OASI Benefits for the Aged, and Benefits for Dependents and Survivors

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals			Corporations	Total
	Disability insurance benefits	OASI benefits for aged	Benefits for dependents and survivors		
1977	370	3, 525	565	----	4, 460
1976	315	3, 045	495	----	3, 855
1975	275	2, 740	450	----	3, 465

Authorization

I.T. 3194, 1938–1 C.B. 114 and I.T. 3229, 1938–2136, as superseded by Rev. Rul. 69–43, 1969–1 C.B. 310; I.T. 3447, 1941–1 C.B. 191, as superseded by Rev. Rul. 70–217, 1970–1 C.B. 12.

Description

Social security benefits to persons who are aged, disabled, or the widow or widower of a spouse who participated in the system, are not included in gross income and thus are tax exempt.

Impact

The elderly benefit most from this treatment, since most social security payments are made to the elderly. The tax saving per dollar of exclusion increases with the marginal rate of the taxpayer. Therefore, the exemption is worth much less to a recipient whose income comes solely from social security benefits, than to recipients with substantial amounts of taxable income. Note that the supplemental security income program (SSI) provides direct income support to only low-income aged, blind, and disabled persons.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class	Percentage distribution: Disability insurance benefits	OASI benefits for aged	Benefits for dependents and survivors
0 to $7,000	51.9	51.8	52.4
$7,000 to $15,000	31.9	31.6	31.7
$15,000 to $50,000	14.0	14.0	13.4
$50,000 and over	2.1	2.6	2.4

Rationale

The exemption for social security payments has never been established by statute; it derives from administrative ruling I.T. 3447, issued in 1941. A Supreme Court decision in 1937 and a 1938 IRS ruling regarding lump sum payments were influential in resolving the issue. In 1937, the Supreme Court characterized social security as "general welfare" (*Helvering* vs. *Davis*, 301 U.S. 619, 640). Two 1939 rulings made lump sum distributions nontaxable (I.T. 3194 and I.T. 3229); internal memoranda suggested that the payments were considered in the nature of a gift. The reasons underlying the 1941 IRS ruling on monthly payments appear to include: (1) the benefits are gratuities and thus not subject to income tax because gifts are not taxable; (2) Congress indicated its intent that the benefits not be taxable since it did not specifically make them taxable; and (3) the benefits are in the nature of public assistance for the general welfare and Congress did not intend to take money from one pocket and put it into another.

Further Comment

There have been proposals to include these payments in taxable income to the extent payments exceed employee contributions, and to adjust allowances, such as the personal exemption and standard deduction (including the low income allowance) to afford tax relief to persons below a determined income level. However, the distribution of net (after-tax) benefits would generally differ from the distribution of nontaxable benefits. Therefore, if benefits were to be made taxable, the benefit structure might require adjustment. There also could be substantial administrative difficulties in taxing the portion of the benefits which exceeded employee contributions.

Selected Bibliography

Goode Richard. *The Individual Income Tax,* Rev. ed. The Brookings Institution, Washington, D.C., 1976, pp. 103–07.

Groves, Harold. *Federal Tax Treatment of the Family,* Chapter III—Tax Treatment of the Aged and Blind, The Brookings Institution, Washington, D.C., 1964, pp. 47–55.

EXCLUSION OF RAILROAD RETIREMENT BENEFITS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	200	------	200
1976	185	------	185
1975	170	------	170

Authorization

45 U.S.C. 228, Railroad Retirement Act of 1935, as amended.

Description

Benefits paid under the Railroad Retirement Act are tax exempt.

Impact

This exclusion benefits retired members of the Railroad Retirement System. Payments generally are larger than those under social security.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	Percentage distribution
0 to 7	51. 9
7 to 15	31. 9
15 to 50	13. 8
50 and over	2. 5

Rationale

While this exclusion has a statutory foundation, the reasons supporting it have not been stated. Presumably they are similar to those stated for social security. (See p. 104, above.)

Further Comment

The questions relating to tax treatment of railroad retirement benefits are similar to those arising in connection with social security benefits. (See p. 104, above.)

Selected Bibliography

Goode, Richard. *The Individual Income Tax*, Rev., ed. The Brookings Institution, Washington, D.C., 1976 pp. 103–07.

Groves, Harold. *Federal Tax Treatment of the Family*, Chapter III—Tax Treatment of the Aged and Blind, The Brookings Institution, Washington, D.C., 1964, pp. 47–55.

EXCLUSION OF SICK PAY

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	350	------	350
1976	330	------	330
1975	315	------	315

Authorization

Section 105(d).

Description

To a limited extent, benefits received by employees (but not self-employed individuals) under accident and health plans financed wholly or partially by employers may be excluded from gross income. The exclusion applies only to amounts paid as wages or as a wage substitute during an employee's absence from work due to injury or sickness. If sick pay exceeds 75 percent of the employee's regular wages, amounts attributable to the first 30 days of absence are included in income. An employee whose sick pay is 75 percent or less of his regular weekly rate of pay may exclude up to $75 a week, starting from the first day he is absent if he is hospitalized for at least 1 day, or otherwise after 7 days. In all cases, amounts for the period after the first 30 days can be excluded only up to $100 per week.

Impact

The sick pay exclusion is designed to reduce the tax burden of individuals during extended illness. It also allows some taxpayers to exempt a portion of their disability pensions until they reach normal retirement age, whereupon the payments are taxed as pensions.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	16. 9
7 to 15	35. 3
15 to 50	45. 9
50 and over	2. 0

67-312—76——8

Rationale

The sick pay exclusion was first enacted in 1954. Prior to that time, employers' payments to employees under accident and health insurance plans had been excluded from income. According to the Ways and Means Committee report, the rationale was to equalize the treatment of employer-financed sick pay plans with the treatment of payments financed under plans contracted with insurance companies. The limitations and extended waiting periods were adopted in 1964.

Further Comment

H.R. 10612, passed by the House in 1975, would limit the sick pay exclusion to those who are retired on disability and are permanently and totally disabled.

Selected Bibliography

Goode, Richard. *The Individual Income Tax*, Rev. ed. The Brookings Institution, Washington, D.C., 1976, pp. 107-09.

Wentz, Roy, "An Appraisal of Individual Income Tax Exclusions," in U.S. Congress, House, Committee on Ways and Means, *Tax Revision Compendium*, 1959, pp. 329–40.

EXCLUSION OF UNEMPLOYMENT INSURANCE BENEFITS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	2, 855	------	2, 855
1976	3, 305	------	3, 305
1975	2, 300	------	2, 300

Authorization

I.T. 3230, 1938–2, C.B. 136; Rev. Rul. 70–280, 1970–1 C.B. 13.

Description

Taxpayers may exclude unemployment compensation benefits from gross income; thus these benefits are not taxed.

Impact

The tax benefit from this provision depends upon the amount of unemployment compensation received, and the tax savings per dollar of tax exempt income increases with the taxpayer's marginal income tax bracket. Therefore, the exemption is of little value to a recipient with no other sources of income but of increasing value to taxpayers with either a spouse who earns a substantial salary, substantial investment income, or high salaries they earned themselves during the part of the year they were employed.

Moreover, lower income taxpayers are often ineligible for unemployment compensation programs because they have worked in occupations not covered by unemployment insurance or for too short a period to qualify for the payments. The tax savings per recipient in 1970 were estimated to be nearly twice as high in families with incomes above $25,000 as in families with incomes under $5,000.

A recent study cited below noted that in 1970 unemployment benefits averaged about two-thirds of net earnings (i.e., earnings minus social security and other Federal, State, and local taxes). Benefits that are high relative to net earnings because they are tax exempt offer a better cushion against financial hardship during unemployment, but at the same time they may discourage the seeking of new employment. Taxation of the benefits might reduce this disincentive effect upon some of the recipients with substantial amounts of taxable income.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	21. 9
7 to 15	39. 0
15 to 50	33. 3
50 and over	5. 7

Rationale

There is no statutory basis for this provision. The decision to exempt unemployment compensation benefits from income taxation was made administratively by the Treasury Department in a 1938 ruling.

Selected Bibliography

Feldstein, Martin, "Unemployment Compensation: Adverse Incentives and Distributional Anomalies," *National Tax Journal*, Vol. 27 (June 1974), pp. 231–44.

EXCLUSION OF WORKER'S COMPENSATION BENEFITS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	640	------	640
1976	555	------	555
1975	505	------	505

Authorization

Section 104(a)(1).

Description

Worker's compensation benefits are not taxable.

Impact

Similar to the sick pay exclusion, the provision reduces tax burdens during periods of illness. It also exempts benefits for permanent injuries. The benefit amounts are specified by State law (in contrast to the sick pay exclusion, where payments are subject to the employer's discretion).

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	22.1
7 to 15	38.5
15 to 50	33.7
50 and over	5.8

Rationale

A rationale for this provision is not offered in the committee reports accompanying its enactment in 1918.

Further Comment

The level of worker's compensation is specified by law and is related to salary level. Minimum and maximum benefit levels apply and payments are based on degree of disability and may be related to family size, but not to the amount of other family income. If the benefits were made taxable, their level and structure might require adjustment.

Selected Bibliography

Goode, Richard. *The Individual Income Tax*, Rev. ed. The Brookings Institution, Washington, D.C., 1976, pp. 107–09.

Wentz, Roy, "An Appraisal of Individual Income Tax Exclusions," U.S. Congress, House, Committee on Ways and Means, *Tax Revision Compendium*, 1959, pp. 329–40.

EXCLUSION OF PUBLIC ASSISTANCE BENEFITS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	130	------	130
1976	115	------	115
1975	105	------	105

Authorization

No general statutory authorization. A number of revenue rulings under section 61 have declared specific types of public assistance payments excludable.

Description

Individuals may exclude public assistance payments from income; thus the payments are tax exempt.

Impact

Because of the level of public assistance payments and other income of recipients, most individuals who receive these payments would have no income tax liability even if the payments were taxable. Those who do benefit from the exclusion tend to be those who receive high public assistance payments or who receive public assistance during part of the year and are employed the remainder. There is no conclusive evidence that the tax treatment affects the recipients' incentive to work.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	93. 3
7 to 15	6. 7
15 to 50	0
50 and over	0

Rationale

Revenue rulings generally exclude government transfer payments from income because they are considered to be general welfare payments. While no specific rationale has been advanced for this exclusion, the reasoning may be similar to that for social security payments—that they are in the nature of gifts, and that Congress did not intend to tax with one what it pays out with the other.

Further Comment

Perhaps the major question involved in the tax treatment of public assistance payments is whether they should be excluded from taxable income or whether exemptions in the tax law designed to remove low-income individuals from the tax rolls are sufficient. Thus, if the present level of exemptions reflects a general agreement on an income level below which taxes are not to be paid, a case might be made for including public assistance payments in income, just as are other receipts.

Selected Bibliography

Goode, Richard, *The Individual Income Tax*, Rev. ed., The Brookings Institution, Washington, D.C., 1976, pp. 100–03.

NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS

EMPLOYER PLANS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	6, 475	------	6, 475
1976	5, 745	------	5, 745
1975	5, 225	------	5, 225

Authorization

Sections 401–407, 410–415.

Description

Employer contributions to qualified pension and profit-sharing plans on behalf of an employee are excluded from the employee's income, but generally constitute currently deductible business expenses for the employer. Investment income of such plans (including that attributable to employer contributions) is exempt. The employee is taxed only on amounts which he receives (with appropriate adjustment where he has contributed). For this treatment to apply, the plan must be "qualified", i.e., must satisfy a number of statutory requirements including nondiscrimination, participation, and vesting.

Impact

The tax expenditure is composed of two elements: (1) the average employee's marginal tax rate will be lower during his retirement years than during his working life because of lower income and special tax provisions for the aged; and (2) current aggregate pension contributions and investment income which are not taxed exceed aggregate amounts paid out as taxable benefits.

Once an employee's rights to a pension become nonforfeitable, he enjoys a tax deferral which is the equivalent of an interest free loan. There are conflicting views concerning whether employers also enjoy tax deferral. Their deductions may be viewed as accelerated from the time the employee's rights become nonforfeitable to the time at which the contributions are made. Under this view, the employer's liability is to pay pensions when due, and making the contribution amounts to a shifting of the form of the employer's assets. On the other hand, it is argued that the employer's deduction is not accelerated because the contribution discharges a current expense, the pension cost for the current period.

The employees who benefit from this provision are primarily middle and upper income taxpayers whose employment has been sufficiently continuous for them to qualify for benefits in a company or union-administered plan.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	3. 7
7 to 15	22. 5
15 to 50	57. 0
50 and over	16. 8

Rationale

This provision was adopted initially in 1921. It was apparently designed to encourage receptivity to employer established retirement programs.

Selected Bibliography

U.S. Congress, House Committee on Ways and Means, Panel Discussions. *General Tax Reform*, Part 7—Profit Sharing and Deferred Compensation, February 22, 1973.

"New Developments in Tax Administration and Pension Plans", Symposium, *National Tax Journal*, September 1974.

NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS

Plans For Self-Employed and Others

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	965	------	965
1976	770	------	770
1975	390	------	390

Authorization

Sections 401–405, 408–415.

Description

Self-employed individuals may exclude from gross income 15 percent of their earned income or $7,500 a year, whichever is less, for contributions to a qualified tax exempt retirement plan.

Any employee not covered by a government pension plan or a qualified retirement plan may set up a tax exempt individual retirement account (IRA) with tax deductible contributions up to the lesser of $1,500 per year or 15% of compensation.

Payments received from either type of retirement plan are included in income for tax purposes.

Impact

These provisions, like those for employer plans, allow deferral of tax liability both on the deductible contributions themselves and the earnings of the fund. This is equivalent to an interest-free loan. In addition, when the individual receives the payments from the fund, he is likely to be in a lower tax bracket than during his earning years due to the probability of reduced income and the existence of other tax provisions which reduce the tax liability of the elderly and retired.

The tax benefits of self-employed plans are enjoyed more by higher income individuals than are those of employer plans because professional and other higher income self-employed individuals are more likely to be able to set aside the maximum contribution amounts. The extent to which the provision encourages more saving, rather than changing the form in which the wealth is held, is uncertain.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	.4
7 to 15	3.5
15 to 50	51.3
50 and over	44.8

Rationale

The exclusion for self-employed individuals is intended to provide treatment similar to that afforded employees securing benefits under employers' qualified plans. This legislation was enacted in 1962. It was considerably liberalized in 1974 when the provision for individual retirement accounts (IRAs) was enacted.

Further Comment

Several questions continue to be raised apart from the basic issue of a tax exclusion for saved income: Should the dollar limitation on self-employed plans differ from that of the individual retirement accounts? Should there be dollar limitations on such plans when there are none on employer plans? Should those who are covered by employer plans be allowed to deduct the difference between their employer's contribution and the maximum limitations provided in the law?

Selected Bibliography

U.S. Congress, House, Committee on Ways and Means, Panel Discussions. *General Tax Reform,* Part 7—Pensions, Profit-sharing, and Deferred Compensation, February 22, 1973, pp. 913–1168.

Schmitt, Ray, "Limitations on Private Pension Benefits and Contributions—Problems in Establishing Equitability." Library of Congress. Congressional Research Service, Multilith 75–162ED, July 11, 1975, 62 pages.

U.S. Congress, House, Subcommittee on Oversight of the Committee on Ways and Means, *Survey Report on Individual Retirement Accounts,* Prepared by the Education and Public Welfare Division, Congressional Research Service, Library of Congress, November 17, 1975, 24 pages.

EXCLUSION OF OTHER EMPLOYEE BENEFITS

Premiums on Group Term Life Insurance

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	895	------	895
1976	805	------	805
1975	740	------	740

Authorization

Section 79, L.O. 1014, 2 C.B. 8 (1920).

Description

Employer payments of employee group term life insurance premiums for coverage up to $50,000 are not included in income by the employee. Since life insurance proceeds are not subject to income tax, the value of this fringe benefit is never subject to income tax.

Impact

These insurance plans, in effect, provide additional income to employees. Since neither the value of the insurance coverage nor the insurance proceeds are taxable, this income can be provided at less cost to the employer than the gross amount of taxable wages which would have to be paid to employees to purchase an equal amount of insurance. Group term life insurance is a significant portion of total life insurance covering over 90 million policies and accounting for over 40 percent of all life insurance in force. Individuals who are self-employed or who work for an employer without a plan do not have the advantage of a tax subsidy for life insurance protection.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	7.4
7 to 15	32.4
15 to 50	50.7
50 and over	9.6

Rationale

This exclusion was originally allowed, without limitation as to coverage, by administrative legal opinion (L.O. 1014, 2 C.B. 8 (1920)). The reason for the ruling is unclear, but it may have related to supposed difficulties in valuing the insurance to individual employees since the value is closely related to age and other mortality factors. Studies later indicated valuation was not a problem. The limit on the amount subject to exclusion was enacted in 1964. Reports accompanying that legislation reasoned that the exclusion would encourage the purchase of group life insurance and assist in keeping the family unit intact upon death of the breadwinner.

Selected Bibliography

The Life Insurance Fact Book, 1975.

U.S. Congress, House, Committee on Ways and Means, *Hearings on President's 1963 Tax Message*, February 6, 7, 8, and 18, 1963, pp. 108–13.

EXCLUSION OF OTHER EMPLOYEE BENEFITS

Premiums on Accident and Accidental Death Insurance

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	60	------	60
1976	55	------	55
1975	50	------	50

Authorization

Section 106.

Description

Premiums paid by employers for employee accident and accidental death insurance plans are not included in the gross income of employees and, therefore, are not subject to tax.

Impact

As with term life insurance, since the value of this insurance coverage is not taxable, the employer would have to pay more in wages, which are taxable, to confer the same benefit on the employee. Employers thus are encouraged to buy such insurance for employees. Insurance awards to employees for accidents and accidental death are generally exempt from income tax.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	7.5
7 to 15	32.5
15 to 50	50.0
50 and over	10.0

Rationale

This provision was added in 1954. Previously, only payments for plans contracted with insurance companies could be excluded from gross income. The committee report indicated this provision equalized the treatment of employer contributions regardless of the form of the plan.

Selected Bibliography

Guttentag, Joseph F., E. Deane Leonard, and William Y. Rodewald, "Federal Income Taxation of Fringe Benefits: A Specific Proposal," *National Tax Journal*, September 1953, pp. 250–72.

U.S. Congress, House, Committee on Ways and Means, "An Appraisal of Individual Income Tax Exclusions" Prepared by Roy Wentz for the House Committee on Ways and Means, *Tax Revision Compendium*, 1959, pp. 329–40.

EXCLUSION OF OTHER EMPLOYEE BENEFITS

Privately Financed Supplementary Unemployment Benefits

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	5	------	5
1976	5	------	5
1975	5	------	5

Authorization

Section 501(c)(17).

Description

Employer payments into a qualified supplementary unemployment insurance benefit trust are not taxable income to the employees when paid into the trust, nor are the earnings of the trust fund taxable as they accrue. The payments into the fund are deductible as business expenses by the employer. Benefits paid out are taxable to employees only upon receipt.

Impact

The employer contributions and earnings thereon provide a fringe benefit for the employees. In effect, these contributions buy unemployment insurance coverage for each employees. As in the case of insurance premiums paid by employers to cover their employees, the employer would have to pay more in wages which would be taxable, to confer the same value of benefits on the employees as he does by making payments into these qualified benefit trusts.

Such plans are particularly attractive in industries affected by cyclical unemployment. Data collected in the mid-sixties indicated that these plans were concentrated primarily in the auto, steel, garment, and rubber industries.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	20.0
7 to 15	60.0
15 to 50	20.0
50 and over	0

67-312—76——9

Rationale

The specific exemption relating to such plans (501(c)(17)) was enacted in 1960. However, such plans could also qualify for exemption under 501(c)(9), predecessors of which have been in the tax law since its inception. The 501(c)(17) exemption was made to allow the qualification of plans that did not otherwise qualify under section 501(c)(9), primarily because of limitations on investment income.

Selected Bibliography

U.S. Department of Labor, *Major Collective Bargaining Agreements—Supplemental Unemployment Benefit Plans and Wage-Employment Guarantees*, Bulletin No. 1425-3, June 1965, 108 pages.

EXCLUSION OF OTHER EMPLOYEE BENEFITS

Meals and Lodging

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	305	------	305
1976	285	------	285
1975	265	------	265

Authorization

Section 119.

Description

Employees exclude from income the value of meals and lodging furnished by the employer on his business premises and for his convenience; the lodging must be required as a condition of employment.

Impact

Meals and lodging furnished by the employer may, in certain cases, constitute a very large portion of the employee's compensation (e.g., in the case of a live-in housekeeper or an apartment resident manager). The value to the employee of such in-kind income in some cases may be difficult to establish. For example, the lodging may simply duplicate rather than substitute for private quarters. The value of the exclusion depends on the value of the income in-kind and the tax bracket of the employee. To the extent that money wages are lower as a result of the tax benefit, employment is subsidized in occupations which involve this type of income in-kind.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	7.4
7 to 15	32.0
15 to 50	50.9
50 and over	9.7

Rationale

The convenience-of-the-employer rule has been in the tax regulations since 1918, presumably in recognition of the problems discussed above. Treatment of such payments was handled through regulation and court decisions until 1954. The regulations suggest that immediately prior to the 1954 Act, meals and lodging that were in the nature of compensation (i.e., taken into account in computing salary) were included in income even if they were for the convenience of the employer. The specific statutory language was adopted to end the confusion regarding the tax status of such payments by precisely defining the conditions under which such meals and lodgings were taxable.

Further Comment

The difficulty in many cases in valuing these benefits is cited as a major argument against taxing such benefits. On the other hand, this argument is challenged by others who cite the fact that these payments are valued under the social security law and under many State welfare laws.

Selected Bibliography

Kahn, C. Harry. *Employee Compensation Under the Income Tax*, National Bureau of Economic Research, New York, 1968, pp. 82–7.

Guttentag, Joseph H., E. Deane Leonard, and William Y. Rodewald, "Federal Income Taxation of Fringe Benefits: A Specific Proposal," *National Tax Journal*, September 1953, pp. 250–72.

EXCLUSION OF INTEREST ON LIFE INSURANCE SAVINGS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	1,855	------	1,855
1976	1,695	------	1,695
1975	1,545	------	1,545

Authorization

Section 101(a) and case law interpreting Treas. Reg. 1.451–2.

Description

Most life insurance policies, other than term policies, accumulate interest bearing reserves which benefit the policyholder by, in effect, reducing his premiums. However, this interest is not included in the policyholder's income for tax purposes as it accumulates. Pursuant to section 101(a), policy proceeds paid because of the death of the insured usually are not included in income. Therefore, when policy proceeds are not taxed at death, the previously accumulated interest is not taxed at all. If a policy is surrendered before death, only the excess of the cash surrender value over the premiums paid is included in income, with the result that the cost of the current insurance and initial expense charges can be offset against the interest income.

Impact

The effect of this exclusion allows personal insurance to be partly purchased with tax-free interest income. Although the interest earned is not currently paid to the policyholder, he may receive the interest payments if he terminates the policy. In the case of a surrender, the deferral of tax on this income is equivalent to an interest-free loan. Furthermore, there is usually no taxable income at death or on other payment of the proceeds, and thus the interest income is usually exempt from tax.

This provision thus offers preferential treatment for the purchase of life insurance coverage and for savings held in life insurance policies. Because middle income taxpayers are the major purchasers of this insurance, they are the primary beneficiaries of the provision. Higher income taxpayers who are not seeking insurance protection, can obtain comparable, it not better, yields from tax-exempt State and local obligations.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	Percentage distribution
0 to 7	11.3
7 to 15	22.5
15 to 50	41.5
50 and over	24.6

Rationale

The exclusion of death benefits dates back to the 1913 tax law. While no specific reason was given for exempting such benefits, insurance proceeds may have been excluded because they are comparable to bequests which also were excluded from the tax base.

The nontaxable status of the interest as it accumulates is based upon the general tax principle of "constructive receipt", i.e., that income is only taxable to a cash basis taxpayer when it is received by, or readily available to, him. The interest income is not viewed as readily available to the policyholder because he must give up the insurance protection by surrendering the policy in order to obtain the interest.

Further Comment

Although significant practical, social, and legal questions would be involved, the interest component could be taxed as earned or could be taxed when the proceeds are paid. Taxing the interest element when the proceeds are paid would still defer tax for the period from when it is earned until the time the proceeds are paid.

Selected Bibliography

Goode, Richard. *The Individual Income Tax*, Rev. ed., The Brookings Institution, Washington, D.C., 1976, pp. 125–33.

McLure, Charles E., "The Income Tax Treatment of Interest Earned on Savings in Life Insurance," in U.S. Congress, Joint Economic Committee, *The Economics of Federal Subsidy Programs*, Part 3—Tax Subsidies, July 15, 1972, pp. 370–405.

EXCLUSION OF CAPITAL GAINS ON HOUSE SALES IF OVER 65

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	50	------	50
1976	45	------	45
1975	40	------	40

Authorization

Section 121.

Description

An individual who has reached 65 years of age may exclude from taxable income some or all of the gain realized from selling the house used as his principal residence for at least 5 of the 8 years before the sale.

If the residence is sold for $20,000 or less, none of the gain is taxable. If the residence is sold for more than $20,000, only a part of the gain—calculated by multiplying the gain by the ratio of $20,000 to the sales price—is not taxed.

The provision can be used only once by a taxpayer.

Example

A residence that cost $30,000 is sold for $40,000. The $10,000 gain is multiplied by $20,000/$40,000 so $5,000 is excluded from tax. Similarly, if the same residence were sold for $60,000, one-third ($20,000/$60,000) of the $30,000 gain, or $10,000, would be excluded.

Impact

This provision benefits elderly persons who sell their homes and do not purchase replacement homes. The benefits of this provision are more concentrated among higher income taxpayers than are some other provisions benefiting the aged (such as social security and the retirement income credit). Other things being equal, there is an incentive for the homeowner to wait until age 65 before selling the house. Viewed in conjunction with section 1034 (which permits deferral of tax on gain realized upon the sale of a residence when a more expensive residence is purchased within 18 months), section 121 allows a permanent exemption of some or all of the gain realized on prior home sales which met the requirements of section 1034.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	10.0
7 to 15	20.0
15 to 50	30.0
50 and over	40.0

Rationale

This provision was added to the tax law in 1964 to provide relief for elderly taxpayers who sell their houses to rent apartments or make other living arrangements. The committee report noted that section 1034 (see p. 73) often did not help the elderly who desired to purchase a smaller house or rent an apartment.

Further Comment

Most of the legislative proposals regarding this provision would raise the $20,000 ceiling to reflect the impact of inflation, or extend the exclusion to all taxpayers regardless of age.

Selected Bibliography

U.S., Congress, House, Committee on Ways and Means, Panel Discussions. *General Tax Reform*, Part 2—Capital Gains and Losses (note, particularly, testimony of Kenneth B. Sanden, p. 254).

DEDUCTIBILITY OF CASUALTY LOSSES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	330	------	330
1976	300	------	300
1975	280	------	280

Authorization

Section 165(c)(3).

Description

To the extent it exceeds $100, the uninsured portion of losses attributable to theft, fire, storm shipwreck, or other casualty, may be deducted from adjusted gross income.

Impact

This provision grants some financial assistance to those who suffer casualties, have tax liability, and itemize deductions. It shifts part of the loss from the property owner to the general taxpayer and thus serves as a form of insurance. The same dollar amount of loss has a proportionately greater effect on a low-income family than on a higher income family, yet the insurance feature of the deduction is greater for taxpayers in higher income tax brackets.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	2.7
7 to 15	28.2
15 to 50	45.5
50 and over	23.5

Rationale

The deduction for casualty losses was allowed under the original 1913 income tax law without distinction between business-related and nonbusiness-related losses. No rationale was offered then. In 1964, the $100 floor on the deduction was enacted, and the purpose of relieving hardship was articulated in the legislative history.

Further Comments

Several proposals to limit the casualty loss deduction have been made. The most common proposal would permit a deduction for only as much of the loss as exceeds 3 percent of adjusted gross income. Proposals of this nature have been made at various times by the Treasury Department, members of the Ways and Means Committee, and others. This approach would continue relief for very large losses (in relation to income) but would remove the deduction for relatively smaller losses.

Selected Bibliography

Kahn, C. Harry. *Personal Deductions in the Federal Income Tax*, Princeton, Princeton University Press, 1960, pp. 1–6 and 156–61.

Goode, Richard. *The Individual Income Tax*, Rev. ed., the Brookings Institution, Washington, D.C., 1976, pp. 153–55.

EXCESS OF PERCENTAGE STANDARD DEDUCTION OVER LOW INCOME ALLOWANCE

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	1,560	------	1,560
1976	1,465	------	1,465
1975	1,385	------	1,385

Authorization

Section 141.

Description

Taxpayers who do not itemize deductions may claim the standard deduction, which is calculated as a percentage of adjusted gross income (AGI), subject to both a maximum and a minimum dollar amount. The minimum amount is commonly referred to as the low income allowance.

Before temporary changes were made in 1975, the percentage standard deduction was 15 percent of AGI up to $2,000 ($1,000 for married persons filing separately), and the low-income allowance was $1,300 ($650 for married persons filing a separate return). These limits will be reinstated in 1977 if the present temporary limits are not continued.

The Tax Reduction Act of 1975 increased the percentage standard deduction to 16 percent of AGI up to $2,300 for single returns, $2,600 for married persons filing joint returns and $1,300 for married persons filing separate returns. The low-income allowance was increased for these taxpayers to $1,900, $1,600 and $950 respectively. These amounts apply to 1975 tax returns.

The Revenue Adjustment Act of 1975 increased the standard deduction for 1976 only to 16 percent of AGI subject to a maximum of $2,200 for single persons, $2,400 for married persons filing joint returns, and $1,200 for married persons who file separately. The purpose of the act is to effect a 6-month tax cut based on annual maximums of $2,400, $2,800, and $1,400 respectively; if the cut is extended for a full year, these latter amounts will be the statutory limits.

Similarly, the low-income allowance for 1976 returns now is $1,500 for single persons, $1,700 for married persons filing jointly, and $850 for married persons filing separately; if the cuts are extended for a full year, the amounts would be $1,700, $2,100, and $1,050 respectively.

Impact

The minimum standard deduction was first adopted in 1964 and was expanded and renamed the low income allowance in 1969. The total of the low-income allowance and the personal exemptions has roughly corresponded to the poverty income level. The amount is viewed as a floor below which income should not be taxed. The standard deduction is granted in lieu of all so-called itemized deductions (see Appendix A). To the extent it exceeds the comparable low income allowance, it is a tax expenditure since it substitutes for a series of individual itemized deductions that are tax expenditures. A low-income allowance of $1,700 and $2,100 for single and joint returns respectively exceeds the percentage standard deduction if AGI is not greater than $10,625 and $13,125 respectively. The tax expenditure thus is limited to those with AGI levels above those amounts.

Until recent years, the standard deduction was chosen by nearly all persons who did not own their own homes and could not deduct mortgage interest and property taxes. With the rise in State and local taxes, a slightly larger group finds itemizing more advantageous than the standard deduction.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class [1]

Adjusted gross income class (thousands of dollars):	Percentage distribution
0 to 7	1. 1
7 to 15	56. 3
15 to 50	42. 1
50 and over	. 6

[1] The distribution table reflects tax law in 1974.

Rationale

The standard deduction was introduced into the income tax structure in 1944. At that time the amount allowed was 10 percent of AGI up to a maximum of $500. The minimum standard deduction was introduced in 1964 and replaced by the low-income allowance in 1969. The original objective of the standard deduction was to simplify the tax structure by eliminating the need to itemize personal deductions. The low-income allowance was designed to remove poverty level families from the tax rolls.

Selected Bibliography

Goode, Richard. *The Individual Income Tax*, Rev. ed. the Brookings Institution, Washington, D.C., 1976, pp. 216–21.

Kahn, C. Harry *Personal Deductions in the Federal Income Tax*, Princeton, Princeton University Press, 1960, pp. 162–72.

ADDITIONAL EXEMPTION FOR THE BLIND

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	25	------	25
1976	20	------	20
1975	20	------	20

Authorization

Section 151(d).

Description

Blind taxpayers receive a special exemption of $750 in addition to the normal personal exemption. The extra exemption is not available for blind dependents.

Impact

The benefits accrue to taxpayers who are blind or have a blind spouse. Because of their disability, blind persons may incur extra expenses to live at a given standard, and the extra exemption helps compensate for this. The amount of tax relief per exemption increases from $105 to $525 as the marginal tax rate increases from 14 to 70 percent.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	26.7
7 to 15	40.0
15 to 50	26.7
50 and over	6.7

Rationale

Special tax treatment for the blind first appeared in 1943 when additional benefits were available through an itemized deduction. The law was amended in 1948 to offer relief as an exemption so that all blind taxpayers could claim the allowance.

67-312—76——10

Further Comment

Taxpayers with other disabilities such as deafness or paralysis do not receive comparable benefits, nor do nontaxpayers who are blind. Either direct spending assistance for the handicapped or a refundable credit that would be phased down for taxpayers at higher income levels would be more oriented toward the low-income blind than is the present provision. Note that the Supplemental Security Income Program provides direct income support to low-income blind persons, and that blind persons also may be covered under the disability provisions of social security.

Selected Bibliography

Goode, Richard. *The Individual Income Tax.* Rev. ed. Washington, D.C., The Brookings Institution, 1976, pp. 222–23.

Selzer, Lawrence H. *The Personal Exemption in the Income Tax.* New York, National Bureau of Economic Research, 1968, pp. 113–20.

Groves, Harold M. *Federal Tax Treatment of the Family.* Washington, D.C., The Brookings Institution, 1963, pp. 54–55.

ADDITIONAL EXEMPTION FOR OVER 65

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	1,220	------	1,220
1976	1,155	------	1,155
1975	1,100	------	1,100

Authorization

Section 151(c).

Description

An additional personal exemption of $750 is allowed for a taxpayer who is 65 or older.

Impact

The amount of tax relief per exemption increases from $105 to $525 as the marginal tax rate increases from 14 to 70 percent. This provision offers no assistance to elderly persons who have no tax liability.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	25.0
7 to 15	40.3
15 to 50	27.6
50 and over	7.1

Rationale

The additional personal exemption originally was provided in the Revenue Act of 1948 to provide tax relief for the elderly whose income sources were reduced by old age.

Further Comment

The present additional exemption should be viewed within the context of the total transfer payment program currently in force, parts of which only provide cash payments to needy elderly persons. See the comment under the exclusion for social security benefits, page 104.

Selected Bibliography

Groves, Harold M. *Federal Tax Treatment of the Family.* Washington, D.C.: The Brookings Institution, 1963, pp. 52–4.

Seltzer, Lawrence, H. *The Personal Exemption in the Income Tax.* New York, National Bureau of Economic Research, 1968, pp. 113–20.

RETIREMENT INCOME CREDIT

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	110	------	110
1976	120	------	120
1975	130	------	130

Authorization

Section 37.

Description

Subject to limitations, individuals are allowed a tax credit equal to 15 percent of their retirement income. For those under 65, retirement income includes only the taxable portion of public retirement benefits. For those 65 or over, pensions, annuities, certain bond and other interest, gross rents, and dividends are defined as retirement income. In order to qualify, an individual must have earned at least $600 or more in each of any 10 previous years.

Retirement income eligible for the credit is limited to $1,524 for an individual; however, married taxpayers may take a credit on as much as $2,286 if either meets the tests for qualification as long as both are 65 or over. Thus, the maximum credit per person is $229 (15 percent of $1,524).

For those under 62, retirement income must be reduced by all earned income over $900. For those over 62 but under 72, retirement income must be reduced by one-half of earnings over $1,200 and under $1,700 and by all earnings over $1,700. For those over 72, retirement income is not reduced by earned income. However, for all income groups, retirement income must also be reduced by tax exempt pensions or annuities, such as social security benefits.

Example

A husband and wife are both 66 and file a joint return. He meets the 10-year prior earned income test, but she does not. He receives a taxable pension of $4,000, wages of $1,300 for part-time work, and a social security pension of $800. She receives a social security pension of $400 and wages of $1,800. Under the joint method, the retirement income is $686, determined as follows:

Maximum amount upon which credit may be based	$2, 286
Less:	
Husband's social security pension	800
Wife's social security pension	400
One-half of husband's wages over $1,200 but not over $1,700	50
One-half of wife's wages over $1,200 but not over $1,700	250
Wife's wages over $1,700	100
Total	1, 600
Retirement income	686

The retirement income credit under the joint method is $102.90 ($686×15 percent).

Impact

Because the amount of eligible income is reduced by the amount of social security benefits received, the primary beneficiaries of this provision are Federal and some State and local government retirees who do not receive social security benefits. Because the provision is a credit, its value to the taxpayer is affected only by the level of benefits and not by the tax bracket of the recipient. Nevertheless, the benefits from the credit are slightly less concentrated in the lower range of the income scale than the tax relief from the exclusion of social security benefits.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	41. 0
7 to 15	39. 0
15 to 50	19. 0
50 and over	1. 0

Rationale

The retirement income credit was enacted in 1954. It was intended to remove inequities between individuals who received pensions and other forms of retirement income that were not tax exempt and recipients of social security, which is tax exempt. At that time many features of the credit were closely related to the social security benefit system (for example, the maximum eligible retirement income and the earnings test). The provision was amended in 1956, 1962, and 1964 to reflect changes in social security; however, no change has been made in the maximum amount eligible for the tax credit since 1962, even though social security benefits have increased substantially since then.

Further Comment

Substantial criticism of the retirement income credit has developed because its complexity has deterred many taxpayers from using it and because it has not kept pace with changes in social security payments.

Two substantially different proposals have been advanced in response to these criticisms. One would revise the credit to reflect changes in levels of benefits and other social security features, thus reorienting the retirement credit more toward its original purpose. Another approach, reflecting concern about the complexity of the provision, would make it available to all taxpayers age 65 or over without any restrictions on earnings. However, this alternative would continue to reduce the base for computing the credit by the amount of any social security or other tax exempt pension income. H.R. 10612, passed by the House in December 1975, adopted this latter general approach.

Selected Bibliography

U.S. Congress, House, Committee on Ways and Means, *Retirement Income Credit, Child Care Deduction, Qualified Stock Options, and Sick Pay Exclusion*. Prepared by the staff of the Joint Committee on Internal Revenue Taxation, September 22, 1975, pp. 1–4.

EARNED INCOME CREDIT

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	[1] 1,390	------	[1] 1,390
1976	[1] 1,455	------	[1] 1,455
1975	------	------	------

[1] The estimated revenue loss reflects cash refunds of the credit as well as reductions of tax liability. OMB includes the refundable amount in direct outlays in the budget, and not as a tax expenditure. The cash refunds for 1976 are estimated at $1,165 million, and those for 1977 are estimated at $1,110 million.

Authorization

Section 43.

Description

This tax credit is available only to low-income workers who have dependent children and maintain a household. The maximum credit is 10 percent of the first $4,000 of earned income. The credit is reduced by 10 percent of the taxpayer's adjusted gross income (AGI) (or earned income if greater) above $4,000 so that it becomes zero at AGI of $8,000.

The credit is subtracted from tax liability, if any. As contrasted with all previously enacted tax credits, credits in excess of tax liability are paid in cash to the eligible worker.

The Revenue Adjustment Act of 1975 in effect extended this provision at its previous level to June 30, 1976; otherwise it would have expired on December 31, 1975. The extension technically specifies a 5-percent credit for income earned in 1976, which would be increased to 10 percent if the provision is fully extended through December 31, 1976.

Impact

The earned income credit may be viewed as a partial offset to social security taxes on low-income workers. The combined employer-employee social security tax rate is 11.7 percent (5.85 percent paid by each party). Assuming the employee bears the burden of the employer's portion in the form of lower wages, the 10-percent credit offsets 85 percent of the tax.

The credit may help to encourage low-income workers to obtain employment and, thus, reduce the demand for welfare and unemployment benefits. However, it has been argued that many of those most in need of relief may fail to file the tax return necessary to claim the credit.

Rationale

The earned income credit originated in the Tax Reduction Act of 1975. Providing relief from social security taxes for low-income workers was one purpose. Other reasons cited by the Ways and Means Committee include providing relief to low-income people for recent increases in food and fuel prices. Some opponents believe relief of this nature would be more efficiently administered as a reduction of social security tax payments made by low-income wage earners.

Selected Bibliography

U.S. Congress, Senate, Committee on Finance, *Tax Reduction Act of 1975—Report of the Committee on Finance together with Supplemental Views on H.R. 2166*, 94th Congress, 1st Session, Report No. 94–36, March 17, 1975.

John A. Brittain. "Social Security Taxes: Problems and Prospects for Reform Revisited." *Tax Notes*, Washington, D.C. Tax Analysts and Advocates, February 9, 1976, pp. 18–25.

MAXIMUM TAX ON EARNED INCOME

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	580	------	580
1976	480	------	480
1975	400	------	400

Authorization

Section 1348.

Description

Although marginal tax rates rise to 70 percent, the marginal rate on earned taxable income is limited to 50 percent. The amount of income eligible for this maximum tax provision is computed in several steps as follows:

(1) Earned income that represents compensation for personal services, is reduced by the amount of expense connected with earning it. The remainder is earned net income. (2) The ratio of earned net income to adjusted gross income is then multiplied by total taxable income. The result is taxable earned income. (3) This amount is then reduced by certain tax preference income such as capital gains. (4) The result is the amount eligible for the maximum tax on earned income.

The tax rate on other income is not affected.

The maximum tax alternative cannot be used by taxpayers who average income and may not be used by married individuals filing separate returns.

Impact

This provision reduces the tax rate on high levels of earned income. However, because of the offset for tax preference income, the tax benefit is affected not only by the taxpayer's level of earned income but the extent of his preference income. Each dollar of preference income removes (i.e., offsets) a dollar of earned taxable income otherwise eligible for the maximum tax, and taxpayers with very large amounts of preference income may not benefit much from the provision. Thus, the offset acts as a tax on preference income.

Virtually all the tax savings resulting from this preferential rate accrue to taxpayers with $50,000 and over of adjusted gross income.[1]

[1] No estimate of the income distribution of this provision was done by the Treasury Department for Senator Mondale.

Rationale

The maximum tax on earned income was adopted in 1969. Its purpose, as indicated in the Ways and Means Committee report, was to discourage the use of other tax reducing provisions rather than to provide tax relief. It was argued that a major motivation for tax avoidance was to protect earned income from high tax rates. The Senate Finance Committee, in deleting the amendment, questioned whether it was appropriate to reduce tax rates on earned income while still imposing high tax rates on other income, particularly when the taxpayer could use other devices to avoid high taxes on this other income and use the 50-percent maximum tax provision as well. The reduction for preference income, not originally in the House bill, was added in Conference presumably to respond to these objections.

Selected Bibliography

Sunley, Emil M., Jr., "The Maximum Tax on Earned Income," *National Tax Journal*, December 1974, pp. 543–567.

VETERANS' BENEFITS AND SERVICES

(1) Exclusion of Veterans' Disability Compensation
(2) Exclusion of Veterans' Pensions
(3) Exclusion of GI Bill Benefits

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals			Corporations	Total
	Veterans' disability compensation	Veterans' pensions	GI bill benefits		
1977	595	30	280	------	905
1976	590	30	330	------	950
1975	540	25	255	------	820

Authorization

38 U.S.C. 3101.

Description

All benefits administered by the Veterans Administration are exempt from income tax. These include veterans' disability compensation, veterans' pension payments, and educational payments.

Impact

Veterans' service-connected disability compensation payments are related not to income levels, but to the average impairment of earnings capacity in civil occupations resulting from the various injuries.

The pensions paid to qualifying nonservice-disabled and aged veterans are based on "countable" income. Reaching age 65 or older is considered a *de facto* disability. The larger a veterans' countable income is, the smaller his pension will be. Countable income excludes various items, the most significant of which is the earnings of a spouse. Therefore, veterans with the same pension—based on the same countable income—can have quite different amounts of total income when the excluded items are taken into account.

Veterans' educational benefits vary with the number of dependents and type of training.

Based upon the foregoing criteria, beneficiaries of all three major veterans' programs to varying degrees may have amounts of taxable income in addition to their tax exempt veterans' benefits. Thus, the value of tax exemption of these veterans' benefits increases with the marginal tax bracket of the recipients.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class	Percentage distributions		
	Veterans' disability pensions	Veterans' pensions	GI bill benefits
0 to $7,000	29.7	(1)	75.2
$7,000 to $15,000	34.8	(1)	17.6
$15,000 to $50,000	32.8	(1)	6.6
$50,000 and over	2.7	(1)	.7

[1] The percentage distributicn for veterans' pensions is not shown because the available data are inadequate to support the calculation. However, the data which are available indicate the beneficiaries are largely within the 0 to $7,000 AGI class.

Rationale

Since 1917, veterans benefits have been exempt from income tax. The original rationale for the exemption is not clear.

Further Comment

One general issue concerning these benefit programs which has been the subject of discussion is whether net (after tax) benefit differentials should depend on the tax bracket of the recipient. Increases in the amount of direct payments under the programs are alternatives to the current exemptions.

Selected Bibliography

Goode, Richard. *The Individual Income Tax.* Rev. ed. Washington, D.C.: The Brookings Institution, 1976, pp. 100–03.

CREDITS AND DEDUCTIONS FOR POLITICAL CONTRIBUTIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	65	------	65
1976	40	------	40
1975	40	------	40

Authorization

Sections 41 and 218.

Description

A taxpayer is allowed a tax credit equal to one-half of his political contributions to candidates for Federal, State, or local office and to national political parties. The credit cannot exceed $25 for a single individual or $50 for a married couple.

In lieu of the credit, a taxpayer may elect to take an itemized deduction not to exceed $100 for a single individual or $200 for a married couple.

Impact

The credit allows a taxpayer to reduce the cost of a limited amount of political contributions by 50 percent, i.e., for each $2 of contribution—up to the limit of $50 per taxpayer—the Federal Government returns a dollar to the taxpayer in effect matching the taxpayer's contribution. The deduction option is preferable for taxpayers whose income is above the 50-percent bracket. For example, at the maximum rate of 70 percent, the taxpayer's net cost of the first $100 of contributions is $30; i.e., the Government matches the $30 contribution with a $70 contribution. Because of the dollar limitations, this provision is obviously not of great significance to large contributors.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	10. 0
7 to 15	30. 0
15 to 50	50. 0
50 and over	10. 0

Rationale

The credit and deduction for political contributions were adopted with half the current limits as part of the Revenue Act of 1971 and the maximum amounts were increased in 1974. Their purpose was to encourage more widespread financing of political campaigns through small contributions.

Selected Bibliography

U.S. Congress, The Joint Committee on Internal Revenue Taxation, *General Explanation of the Revenue Act of 1971, H.R. 10947*, 92d Congress, Public Law 92–178, December 15, 1972.

EXCLUSION OF INTEREST ON STATE AND LOCAL BOND DEBT

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	1, 390	3, 150	4, 540
1976	1, 280	2, 890	4, 170
1975	1, 130	2, 675	3, 805

Authorization

Section 103.

Description

Interest on the obligations of State and local governments (including, in certain circumstances, "industrial development bonds" [1]) is excluded from gross income.

Impact

Because the interest is exempt from tax, the interest rate on State and local government obligations is lower than the rate on comparable taxable bonds. In effect, the Federal Government subsidizes States and localities by paying part of their interest cost. For example, if the market rate on tax exempt bonds is 7 percent when the taxable rate is 10 percent, there is a 3 percentage point subsidy to State and local governments.

Tax exempt bonds are viewed by some persons as a particularly attractive form of indirect Federal aid because it operates automatically without Federal regulation.

The tax exempt bond provision is estimated to cost the Treasury approximately $1 to deliver $.75 in aid to municipal governments through this means. It is estimated that in fiscal year 1976, $4.8 billion in Federal revenue was foregone to save State and local governments about $3.6 billion in interest costs. The estimated difference of $1.2 billion is tax relief to investors.

Commercial banks and high income individuals are the major buyers of tax exempt bonds. Of the $207 billion in outstanding municipal debt (more than double the $93 billion in 1964), about 50 percent is held by commercial banks and 30 percent by individuals. One study

[1] Industrial development bonds (IDBs) are obligations issued by State and local governments, the proceeds of which are used to purchase industrial plants or equipment. These in turn generally are leased or sold to private firms who in effect pay the interest costs incurred by the State or local governments in issuing the IDBs. Interest on IDBs is taxable except for certain small issues and issues to finance investments in certain exempt facilities including principally those for air and water pollution control.

67-312—76——11

indicated that the tax exemption reduced the tax rate of commercial banks by an average of 19 percentage points.

Tax exempt institutions, such as pension funds, have little incentive to invest in tax-free bonds since the return is much lower than that of other taxable securities. Therefore, the tax exempt nature of State and local debt, in effect, restricts the potential market for these securities.

Commercial banks generally do not consider such bonds as priority items and leave the tax exempt market when money is tight. Tax exempt financing thus is very sensitive to changes in monetary policy.

This tax expenditure subsidizes interest on debt that generally finances capital expenditures such as buildings. Thus, such projects are encouraged in preference to other expenditures that are not financed by debt. Exempt industrial development bonds finance corporate investments such as pollution control facilities.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class [1]

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	0.0
7 to 15	.5
15 to 50	11.3
50 and over	88.2

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

This exemption has been in the income tax law since 1913 and apparently was based on the belief that the Federal Government could not constitutionally tax such interest (e.g., the 1895 Supreme Court decision in *Pollack* v. *Farmers' Loan & Trust Company*). Today this view is no longer as widely held, and the continued exemption is justified principally as a means of assisting State and local governments with a minimum of Federal interference.

Further Comment

Some projections indicate that tax exempt bonds will become somewhat less important as a means of financing State and local capital expenditures because debt-financed programs (such as schools and roads) are growing less rapidly than programs receiving direct Federal support (such as sewers and water resource projects). Industrial development bonds for pollution control may become a major vehicle of tax exempt financing; these bonds would then compete with general purpose municipal bonds.

Two options are frequently mentioned as alternatives or supplements to the exclusion. The first would give States and localities the choice of issuing either taxable or tax exempt bonds. A Federal subsidy then would be provided to those issuing taxable bonds to compensate them for the higher interest cost that would be incurred. This option would, among other results, help expand the municipal bond market. The second option would create a Federally financed development bank that would raise funds by selling taxable bonds at market interest rates, and then lend to States and localities at lower interest rates. Under most initial projections, both options would result in substantial increased long term net outlays by the Federal Government because the direct subsidy payments are expected to exceed the increased income taxes paid by the recipients of the taxable securities.

Selected Bibliography

Bedford, Margaret E., "Income Taxation of Commercial Banks," Federal Reserve Bank of Kansas City, July–August 1975, pp. 3–11.

Galper, Harvey and John Peterson, "Analysis of Subsidy Plans to Support State and Local Borrowing," *National Tax Journal*, Vol. 25 (June 1971).

Huefner, Robert P. *Taxable Alternative Municipal Bonds*, Federal Reserve Bank of Boston Research Report No. 53, 1973.

Fortune, Peter, "Tax Exemption of State and Local Interest Payments: An Economic Analysis of the Issues and an Alternative," *New England Economic Review*, May/June, 1973, pp. 3–31.

Surrey, Stanley S. *Pathways to Tax Reform*, Harvard University Press, Cambridge, Massachusetts, 1973, pp. 210–22.

"The Tax Exemption on State and Local Bonds, A Report to the House Budget Committee," U.S. Congressional Budget Office, (November 18, 1975).

EXCLUSION OF INCOME EARNED IN U.S. POSSESSIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	------	285	285
1976	------	240	240
1975	------	245	245

Authorization

Sections 931–934.

Description

A U.S. corporation engaged in the active conduct of a trade or business within a U.S. possession is taxable only on its U.S.-source income if at least 50 percent of its gross income for the last 3 years is from that trade or business and if at least 80 percent of its gross income during the same 3-year period had its source in a U.S. possession. Without these provisions, the corporation would be subject to U.S. tax on its worldwide income, and would be allowed to credit against this liability the income taxes it paid to the possessions and foreign governments.

This exclusion applies to corporations conducting business in the Commonwealth of Puerto Rico and all possessions of the United States (mainly Guam, the Canal Zone, and Wake Island) except the Virgin Islands. The exclusion also applies to business operations of individuals in some possessions, but not in Guam, and only in Puerto Rico and the Virgin Islands if the individuals reside there.

Impact

The bulk of income earned in U.S. possessions is derived from Puerto Rico. Corporations operating in Puerto Rico account for about 99 percent of the estimated revenue loss from these provisions.

Puerto Rico grants substantial tax holidays (i.e. multi-year tax-free periods) to encourage corporations to engage in manufacturing operations in the Commonwealth. Most "possessions corporations" are subsidiaries of U.S. corporations with United States (and sometimes foreign) operations. Often, instead of paying dividends, which would be taxable to the parent company, a possessions corporation is liquidated—free of U.S. tax—into the corporate parent. Both United States and Puerto Rican tax is avoided completely if such liquidation occurs at the end of a Puerto Rican tax holiday.

Securities and Exchange Commission data indicate that drug corporations, in particular, make substantial use of this provision. For example, data on five drug firms indicate the income qualifying for this exclusion ranged from 9 percent to 21 percent of pre-tax profits.

Rationale

This exclusion was established in 1921. Floor debate indicates it was intended to encourage export trade (especially to South America) by improving the competitive position of U.S. companies in foreign markets. It is now justified as necessary to assist the economic growth of Puerto Rico. The present justification for this provision raises the same issues as the exclusion for State and local bonds, *i.e.* how efficient is the exemption and what is the distribution of benefits?

Further Comment

H.R. 10612 (passed by the House in 1975) would make relatively minor changes with respect to the annual revenue loss from this provision.

Selected Bibliography

U.S. Congress, House, Committee on Ways and Means, *Energy Tax and Individual Relief Act of 1974. Report to accompany H.R. 17488*, No. 93–1502, November 26, 1974, pp. 168–73.

U.S. Congress, House, Committee on Ways and Means, *General Tax Reform*, Panel Discussions, 93rd Congress, 1st Session, Part II—Tax Treatment of Foreign Income, February 28, 1973, pp. 1671–88.

DEDUCTIBILITY OF NONBUSINESS STATE AND LOCAL TAXES (Other Than on Owner-Occupied Homes and Gasoline)

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1977	6, 680	------	6, 680
1976	6, 505	------	6, 505
1975	8, 490	------	8, 490

Authorization

Section 164.

Description

An individual can claim certain State and municipal sales, income, and personal property tax payments as itemized deductions.

Impact

This deduction for State and local tax payments benefits only taxpayers who itemize their deductions. They are concentrated in the middle and higher income brackets, largely among persons who own homes, because these are the taxpayers who generally itemize.

The Federal tax deduction for State and local sales taxes and miscellaneous taxes accentuates the generally regressive nature of these taxes, because the amount of tax benefit per dollar of deduction increases with the tax bracket of the taxpayer. State and local income taxes generally are progressive, but the Federal deduction lessens the effect of their progressivity.

Estimated Distribution of Individual Income Tax Expenditure by Adjusted Gross Income Class

Adjusted gross income class (thousands of dollars):	*Percentage distribution*
0 to 7	1. 0
7 to 15	12. 9
15 to 50	57. 3
50 and over	28. 8

Rationale

The allowance of a deduction for taxes in general has always been a part of the income tax structure including the Civil War income tax. Although the legislative history is not explicit, it suggests that taxes were viewed as reducing net income. Some now regard this treatment as a form of revenue sharing. As with many other deductions, no distinction was made between business and nonbusiness taxes. The deduction for the Federal income tax was eliminated in 1917 and, for Federal excise taxes, in 1943. The deduction was eliminated for State and local taxes on tobacco and alcoholic beverages in 1964, along with automobile and drivers' licenses and other State and local selective excise taxes except gasoline taxes.

Selected Bibliography

Goode, Richard. *The Individual Income Tax*, Rev. ed., Washington, D.C., The Brookings Institution, 1976, pp. 168–71.

Kahn, C. Harry, *Personal Deductions in the Federal Income Tax*, Princeton, Princeton University Press, 1960, pp. 92–108.

Moscovitch, Edward, "State Graduated Income Taxes—A State Initiated Form of Federal Revenue Sharing," *National Tax Journal*, March 1972, pp. 53–64.

Appendix A

FORMS OF TAX EXPENDITURES

Exclusions, Exemptions, Deductions, Credits, Preferential Rates, and Deferrals

Tax expenditures may take any of the following forms: (1) special exclusions, exemptions, and deductions, which reduce taxable income and, thus, result in a lesser amount of tax; (2) preferential tax rates, which reduce taxes by applying lower rates to part or all of a taxpayer's income; (3) special credits, which are subtracted from taxes as ordinarily computed; and (4) deferrals of tax, which result from delayed recognition of income or from allowing in the current year deductions that are properly attributable to a future year.

Computing Tax Liabilities

A brief explanation of how tax liability is computed will help illustrate the relationship between the form of a tax expenditure and the amount of tax relief it provides.

CORPORATE INCOME TAX

Corporations compute taxable income by determining gross income (net of any exclusions) and subtracting any deductions (essentially costs of doing business). Although the first $25,000 of corporate taxable income is taxed at 20 percent and the next $25,000 is taxed at 22 percent,[1] the corporation income tax is essentially a flat rate tax at 48 percent of taxable income in excess of $50,000. Any credits are deducted from tax liability calculated in this way. The essentially flat statutory rate of the corporation income tax means there is very little difference in marginal tax rates to cause variation in the amount of tax relief provided by a given tax expenditure to different corporate taxpayers. However, corporations without current tax liability will benefit from tax expenditures only if they can carry back or carry forward a net operating loss or credit.

INDIVIDUAL INCOME TAX

Individual taxpayers compute gross income which is the total of all income items except exclusions. They then subtract certain deductions (deductions from gross income or "business" deductions) to arrive at adjusted gross income. The taxpayer then has the option of "itemizing" personal deductions or taking the standard deduction. The taxpayer then deducts personal exemptions to arrive at taxable income. A graduated tax rate structure is applied to this taxable

[1] This rate will expire on June 30, 1976, unless extended. The rates will then revert to 22 percent on the first $25,000 and 48 percent on the excess.

income to yield tax liability, and any credits are subtracted to arrive at the net after-tax liability.

Exclusions, Deductions, and Exemptions

The amount of tax relief per dollar of each exclusion, exemption, and deduction increases with the taxpayer's marginal tax rate. Thus, the exclusion of interest from State and local bonds saves $50 in tax for every $100 of interest for the taxpayer in the 50-percent bracket, whereas for the taxpayer in the 25-percent bracket the saving is only $25. Similarly, the extra exemption for persons over age 65 and any itemized deduction is worth twice as much in tax saving to a taxpayer in the 50-percent bracket as to one in the 25-percent bracket.

In general, the following deductions are itemized, i.e., allowed only if the standard deduction is not taken: medical expenses, specified State and local taxes, interest on nonbusiness debt such as home mortgage payments, child care expenses, alimony, certain unreimbursed business expenses of employees, charitable contributions, expenses of investment income, union dues, costs of tax return preparation, uniform costs, and political contributions. Whether or not a taxpayer minimizes his tax by itemizing deductions depends on whether the sum of those deductions exceeds the limits on the standard deduction; higher income individuals are more likely to itemize because they are more likely to have larger amounts of itemized deductions which exceed the standard deduction allowance. Homeowners generally itemize because deductibility of mortgage interest and property taxes generally leads to larger deductions than the standard deduction.

Preferential Rates

The amount of tax reduction that results from a preferential tax rate (such as the 50 percent maximum tax rate on earned income) depends on the difference between the preferential rate and the taxpayer's ordinary marginal tax rate. The higher the marginal rate that would otherwise apply, the greater is the tax relief from the preferential rate.

Credits

A tax credit (such as the investment credit) is subtracted directly from the tax liability that would accrue otherwise; thus, the amount of tax reduction is the amount of the credit and is not contingent upon the marginal tax rate. A credit can (with one exception) only be used to reduce tax liabilities to the extent a taxpayer has sufficient tax liability to absorb the credit. Most tax credits can be carried backward and/or forward for fixed periods so that a credit which cannot be used in the year in which it first applies, can be used to offset tax liabilities in other prescribed years.

The earned income credit is the only tax credit which is now refundable. That is, a qualifying individual will obtain in cash the amount of the refundable credit in excess of his tax liability when he files his tax return for the year in which the credit applies.

Deferrals

Deferral can result either from postponing the time when income is recognized for tax purposes or from accelerating the deduction of expenses. In the year in which a taxpayer does either of these, his taxable income is lower than it otherwise would be, and because of the current reduction in his tax base, his current tax liability is reduced. The reduction in his tax base may be included in taxable income at some later date. However, the taxpayer's marginal tax rate in the later year may differ from the current year rate because either the tax structure or the applicable tax rate has changed. Furthermore, in some cases the current reduction in the taxpayer's tax base may never be included in his taxable income. Thus, deferral works to reduce current taxes, but there is no assurance that all or even any of the deferred tax will be repaid. On the other hand, the tax repayment may even exceed the amount deferred.

A deferral of taxes has the effect of an interest-free loan for the taxpayer. Apart from any difference between the amount of "principal" repaid and the amount borrowed (i.e., the tax deferred), the value of the interest-free loan—per dollar of tax deferral—depends on the interest rate at which the taxpayer would borrow and on the length of the period of deferral. If the deferred taxes are never paid, the deferral becomes an exemption. This can occur if, in succeeding years, additional temporary reductions in taxable income are allowed. Thus, in effect, the interest-free loan is refinanced; the amount of refinancing depends on the rate at which the taxpayer's income and deductible expenses grow and can continue in perpetuity.[2]

TEMPORARY EXCLUSIONS

The Domestic International Sales Corporation (DISC) provision is an example of deferral through a temporary exclusion of income, with recognition of the income for tax purposes occurring subsequently. In some cases the deferral may continue indefinitely and the effect is a permanent exclusion of taxable income.

ACCELERATED DEDUCTIONS

More commonly, deferrals occur through the acceleration in the deduction of expenses. Ordinarily, the cost of acquiring an income-producing asset which undergoes economic decline (such as a machine) is capitalized and deducted over the asset's useful life. The amount of deduction taken in each year depends on the useful life and the rate of depreciation applied. The shorter the useful life and the higher the rates applied, the more quickly deductions are taken. To reflect net income, the share of the asset cost used up in any one year should be deducted as an expense against income produced by the asset in that year. However, if a larger amount is deducted

---

[2] The tax expenditures for deferrals are estimates of the difference between tax receipts under the current law and tax receipts if the provisions for deferral had never been in effect. Thus, the estimated revenue loss is greater than what would be obtained in the first year of transition from one tax law to another. The amounts are long run estimates at the level of economic activity for the year in question.

in earlier years, tax liability is lower than it otherwise would be. Just the reverse is true in later years when the deduction is lower and tax liability is higher than it otherwise would be, and thus a tax deferral occurs.

Rapid write-off methods which are considered tax expenditures include: (1) expensing 100 percent of capital costs as incurred, (2) using a shorter life (as in the asset depreciation range), (3) using a faster rate (as in accelerated depreciation on buildings), and (4) using various 5-year amortization provisions. The tax saving from various rapid write-off methods is illustrated using the following example.

Assume a $10,000 asset with an even rate of economic depreciation over a 10-year life is held by a taxpayer with a marginal tax rate of 50 percent. The appropriate deduction, in this case "straight line", would be $1,000 each year and the resulting annual tax reduction would be $500 (50 percent of $1,000).

Expensing capital acquisitions

If the asset is expensed, the entire amount ($10,000) is deducted in the first year, and the tax reduction is $5,000 (50 percent of $10,000). This tax reduction is $4,500 greater than the $500 amount resulting from the "straight line" method (where 10 percent is written off in each year of the 10-year life). In the second and all following years, no deduction will be taken. Thus, the net effect of expensing the cost of the asset is a $4,500 loan from the government which is paid back without interest over the next 9 years (as no depreciation is deducted).

Shorter than actual useful lives

The use of any life shorter than the "true" 10-year economic life (in this example) provides similar but smaller amounts of tax benefit. If an 8-year life is used instead of a 10-year life, the deduction allowed in each of the first 8 years is $1,250, and the net tax deferral each year is $125 ($1,250–1,000×50 percent) which is ultimately repaid in the last 2 years of the asset's actual useful life when no deductions are taken.

Rapid rate depreciation

There are several rapid rate alternatives to the straight line method. The use of a rapid rate simply allows larger deductions in the earlier years of the asset's useful life (but does not affect the period over which the asset is written off). For example, the declining balance method applies a larger than straight line rate against the balance (i.e., the asset cost less the allowed depreciation) remaining each year. To illustrate with a $10,000 asset, double declining balance depreciation in the first year is 2×1/10×$10,000 or $2,000—twice the straight line depreciation, for a net tax saving of $500 (50 percent of $1,000). In the next year the deduction is 2×1/10×$8,000 or $1,600, for a net tax saving of $300. Although depreciation deductions will continue over the entire life of the asset, they will be larger at the beginning and smaller at the end of the period.

For certain types of machinery and equipment, the pattern of economic decline may be more closely approximated by a rapid depreciation method than by straight line. Indeed, the use of an accelerated depreciation rate for machinery and equipment is not considered a tax expenditure; however, it is considered so for buildings.[3] When, in the latter periods under an accelerated depreciation plan, the allowed expense is less than the actual depreciation, the difference "repays" the loan afforded by the allowance of earlier depreciation in excess of actual.[4]

Five-year amortization

There are several provisions in the tax expenditure budget which allow 5-year amortization. Rapid amortization reduces the taxpayer's liability by calculating straight line depreciation over an arbitrary period—5 years—which is shorter than the actual useful life of the asset. Rapid amortization is a substitute for other depreciation which would have been allowed. In the $10,000 example, 5-year amortization would yield deductions of $2,000 in each of 5 years. Double declining balance depreciation would yield $2,000 the first year, $1,600 the second year and with declining amounts thereafter. However, the investment credit cannot be taken if rapid amortization is used; the taxpayer has the choice of rapid amortization or whatever depreciation is allowed plus the investment tax credit. If a $10,000 asset is eligible for the investment tax credit, an additional $1,000 of tax savings would occur in the first year. Thus, the investment tax credit plus the regular depreciation is likely to be better than 5 year amortization for the taxpayer in this case.

For a given asset, rapid amortization provides more tax saving the longer is the asset's useful life and the higher is the interest rate and the taxpayer's marginal tax rate. In the case of assets eligible for the 10 percent investment tax credit, it is unlikely the 5-year amortization provisions will be a better option. Where the investment tax credit does not apply to capital assets (such as housing rehabilitation expenditures), the 5-year amortization provision results in more tax saving than rapid depreciation if the asset's useful life is long enough.

---

[3] The explanation for this treatment is that the tax depreciation allowed for machinery and equipment is thought to be closer to actual depreciation than that allowed on buildings. See 'The Tax Expenditure Budget: A Conceptual Analysis," *Annual Report of Secretary of the Treasury, FY 1968*, p. 33.

[4] The taxpayer has the option to switch to straight line depreciation of the undepreciated balance and usually may find it beneficial to do so. However, this option does not change the basic result; it simply increases the amount of interest saving.

Appendix B

CAPITAL GAINS

In the income tax law, profit from the sale of most investment assets is referred to as capital gain and receives preferentially lower tax rates. For individuals this lower rate is about one-half the usual rate although capital gains may also be subject to the minimum tax on tax preferences. Corporate long-term capital gains are taxed either as ordinary income of the corporation or at an alternative rate of 30 percent, whichever produces a lower tax.

Broadly speaking, capital gain or loss is produced by the sale or exchange [1] of capital assets.[2] The sale produces "long-term" gain or loss if the property has been owned for more than 6 months. If not, it produces "short-term" gain or loss. While the expression "capital gains" technically includes both long and short-term gains, it generally is used to mean only long-term gains. Only long-term gains receive the preferential treatment.

Stocks and bonds owned by casual investors usually are capital assets. Inventory owned by a retailer is not a capital asset. Between these extremes, whether property is a capital asset is less clear, and in specific cases, the definitional problem may be a very difficult matter. In general, however, the distinction is that investments are capital assets but items held for sale in a business are not.

Another kind of property that may produce long-term capital gain is property used in a business—generally real estate and depreciable property—if it is not held for the purpose of being sold to customers and is owned more than 6 months.[3] Gain on this kind of property is treated as long-term capital gain only if all of the gains for the year exceed all of the losses for the year. If so, the net gain is long-term capital gain.

The gain on a particular sale receives preferential treatment only if it survives a number of complex computations. First, losses on long-term assets are subtracted from gains on long-term assets. Only the net figure survives and is referred to as net long-term gain. Short-term losses which have not been used to eliminate short-term gains are then offset against this net long-term gain. After this offset, any excess is defined by the statute as "net section 1201 gain" but is generally called capital gain and is entitled to preferential treatment.

For individuals, the preference is that one-half of the gain may be deducted, and only the other one-half is subject to tax. If this calculation produces a tax on the first $50,000 of gains which exceeds

---

[1] Capital gain treatment is conferred only if there is a "sale or exchange." Other dispositions, e.g., an abandonment, do not result in capital gain or loss but rather in ordinary gain or loss. This technicality is beyond the scope of this appendix.

[2] This gain or loss will be recognized and taken into income unless one of many non-recognition provisions apply. Non-recognition provisions are beyond the scope of this appendix.

[3] The holding period is longer for some assets, most notably livestock.

25 percent of such gains, the lower 25 percent rate is applied to the first $50,000 of gains. For corporations, the preference results by limiting the tax to no more than 30 percent of the gain.

The increase in value of capital assets is taxed as a capital gain only if the asset is sold. As a consequence, the gross gains on unsold assets accumulate in value without being reduced by any accrued tax.

Without such treatment, accumulation is limited to the after-tax gain. Moreover, capital gains accrued at death are transferred to heirs, and the gain is exempted from income tax. Gains accrued on assets transferred by gift are subject to tax only if the donee sells them before his death.

Note: The following description is provided for the reader who wants a more detailed outline of the way capital gains and losses are treated:

First, the gain or loss must be determined on each transaction involving a capital asset. Then the following procedural rules govern the tax treatment of capital gains and losses:

(1) Long-term gains and losses are aggregated.
(2) Short-term gains and losses are aggregated.
(3) (a) If the aggregations in steps 1 and 2 both result in gains, long-term gain is treated as stated in step 4(a) and short-term gain is treated as stated in step 4(c).
(b) If the aggregations in steps 1 and 2 both result in losses, long-term loss is treated as stated in step 4(b), and short-term loss is treated as stated in step 4(d).
(4) If one of the aggregations in steps 1 and 2 produce a loss and the other a gain, the gain and loss are then aggregated, and the following rules govern:
(a) If the net is long-term gain, one-half of it is deducted by an individual in calculating gross income. An individual may elect for the first $50,000 of such gain to be taxed at a 25 percent alternative rate. Corporate long-term capital gain is either taxed as other corporate income or at the alternative rate of 30 percent, whichever yields the lower tax.
(b) If the net is long-term loss, individuals may deduct one-half of it from other income but not in excess of $1,000 per year. Corporations may not deduct any such loss from other income. There is an unlimited carryover to future years for individuals but no carryback. Corporations generally may carryback for 3 years and carryforward for 5 years, to offset capital gain.
(c) If the net is short-term gain, the entire amount is subject to tax.
(d) If the net is short-term loss, individuals may deduct it against ordinary income but not to exceed $1,000 per year, subject to the previously stated rules on carryovers and carrybacks. Corporations may not deduct any such loss from other income, subject to the rules on carryovers and carrybacks.

O